Canadian Public-Sector Financial Management

3rd Edition

Andrew Graham

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Canadian Public-Sector Financial Management

3rd Edition

Andrew Graham

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Thoughts and Thanks for the Third Edition

I never thought it would come to this, another edition of this text. I also never thought that it would take so much to keep up to date in public sector financial management. This is a dynamic, changing and powerful field. So much has happened that has moved the getting, spending and accounting for resources front and centre in government. The public sector has changed too. We see all kinds of innovation in how governments deliver their programs and the way they relate to citizens in explaining and clarifying what they have done with their money. I see First Nations taking control of their resources, moving towards greater self-determination, by building financial capacity.

I chose to reorganize the text to follow the basic metaphor that I use to explain how I see public sector financial management: getting the resources (budgeting), delivering the services (control and operations) and explaining what was done with the money (reporting and performance measurement). What binds these three elements together is accountability, a basic public sector value and risk, the core concern that builds resilience. I have consistently found people respond to this metaphor. For those in government or studying public administration, the metaphor is similar to the public policy model of creating policy, implementing policy and being held to account for that policy.

When I began this text, governments were on the verge of major changes in financial management. Accrual accounting was only beginning in government. Today it has been fully implemented. As such, I treat it as a *fait accompli* that we still have to understand but not debate. In early days of writing and teaching in this area, accountability to citizens took on very formal, distant and often hard to understand reporting. A lot of that is still there, but the improvements and innovations are impressive with more and more efforts to have citizen-centric reporting that combines formal financial reporting, program performance metrics and ways to communicate it that are innovative, relevant and digitally available.

I have a lot of people to thank for helping get to this stage. More than anything, my students continue to be an inspiration. I asked them what to do with the third edition to make it better. One quite wisely said, "Have it catch up with your lectures and our class discussions." Sound advice as I have continually updated class material, taking into account developments in standards, new ways to communicate and emerging issues. Another student, a Professional MPA students with work experience, told me that in her office in a provincial government, a copy of the second edition could be found in most of the offices in her unit. Her advice was to keep the practitioner in mind, especially the one who had little experience managing a budget. So, advice taken. My colleagues across the country who use the text have provided helpful feedback. Much appreciated. I particularly benefited from advice from Robert Shepherd of Carleton University and Patrice Dutil of Ryerson University. Wise counsel. I have also benefited from an increasing engagement with CPA Canada, the accounting and standards setting organization in our country. It has been insightful to work with leaders in this area from across the country on CPA's Pubic Financial Management Advisory Committee. Through the First Nations Financial Management Board's resources, I have learned much about leading practice among First Nations and the emergency of centres of excellence.

Once again, the School of Policy Studies, Queen's University has been a wonderful environment in which to learn, teach and research. The leadership of Dr. David Walker and Lynn Freeman, as well as their personal support, is much appreciated. So too is that of Mark Howes from our Publications Unit.

My wife, Katherine Graham, continues to be a great support. During the rewriting of this text, she was working on a book of her own with a colleague. We did our daily chapter updates and moved through each other's effort step by step, encouraging along the way without delving into what it was we were actually writing.

Andrew Graham
Kingston, Ontario
December, 2018

Introduction to the Third Edition

"It's All about the Money"*

Chapter Objectives:

- Setting financial management in the public sector context: a framework.
- Describing what a financially literate manager and organization means.

Money matters in government. It gets things done. The art and science of securing funding, spending it to meet public policy objectives in the right way and then being able to report and account for it is what this book is about.

The text is intended for both classroom use and as a reference guide for practitioners. I well recall the point in my own public service career when, upon promotion, I found myself employed as a budget manager for the first time. In the sink-or-swim learning environment, I swam, with more than a little help. Luckily, I found a colleague who would show me the ropes. Luckily, I had financial advisors who would take the time to explain things to the newbie. Luckily, I had a boss with a tolerant view, at least at the outset. This book was written with that experience in mind, not just because it was mine, but because, throughout my public service career and in the years teaching at Queen's, I heard versions of it time and time again. So, for the upcoming public servant who finds herself being called a budget manager or responsibility centre manager, here is a little help to get on board. The focus here is the practical application of financial management to achieve a public good, be it implementing a new policy or operating and sustaining an established program.

The Framework for Financial Management: A Public Policy Implementation Focus

The public sector of Canada is a large and important part of the social, economic and fiscal landscape of this country. Taken at its broadest possible definition, it encompasses a wide range of public activities, some under the title of government, the broader public sector encompassing hospitals and school boards, for example, but also all contracted services and special agencies of government.

The successful delivery of public services, be they policies, regulations, direct client services, or payments of some kind, depends on having the resources available. While the term *resources* embraces many elements – people, time, attention, focus, and capacity – in the end, the amount of money available to deliver the program is the key variable for success. In that sense, it is all about the money.

Effective management of these funds by the managers responsible is the principal focus of this book. As the cycle of public policy outlined in **Figure 0.1** shows, there is more to the public sector than simply spending money, and it all begins with public policies. An array of tools has evolved to deliver public goods under the overall umbrella of the public sector, be it government, near-government agencies, wholly independent public organizations, fully independent nonprofit organizations and private sector firms.[1]

This text is organized to address the elements of this framework, which is represented diagrammatically in **Figure 0.2.** Accounting for the proper expenditure of funds is

1 An excellent discussion of these tools and their implications for public-sector governance in the future is the work of Dr. Lester Salamon, editor, *The Tools of Government: A Guide to the New Governance* (New York: Oxford University Press, 2002).

* This quotation is attributed anecdotally to Tommy Douglas, former Premier of Saskatchewan and former Leader of the New Democratic Party, who was reputed to have said in reference to his dealings with some federal government officials, "When they say that it's not about the money, but about the principles involved, it's all about the money."

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not only an element of good management: it is essential to good government and good governance of the public enterprise. It is also where governments are most heavily scrutinized and where they can get into a great deal of trouble. The Centre for First Nations Governance drives this point home very well:

> Financial Management Capacity ensures that our good work is not derailed by an inability to plan for, monitor, and account for financial resources. Financial capacity permits long-term, multi-year planning and proactive decision making. Effective financial management permits communities to plan beyond the arbitrary end of a fiscal year or a federal funding cycle and instead to plan for generations.[2]

Figure 0.1
Public Policy and Resource Cycle

Policy Direction: The Public Good to be Achieved
Resourcing the Policy Objective: Budgets
Delivering the Public Good: Operations, Control, Risk
Accounting, Evaluating and Reporting

Public policy drives how the public sector operates. Without it, no measure of public activity would make any coherent sense. However, it rarely stops there. Otherwise, we would have no end of interesting public-policy pronouncements, but little or no action to bring them to life. Furthermore, so much of the effectiveness of any policy turns on matching resources to policy aspirations. It is often called "delivering on promises." This process is continuous. Policy direction may be the notional start of the cycle of resourcing and accounting, but time does not stand still and seldom is one policy ever implemented in isolation. A policy may start as one thing but it is often reformulated by the experience of operations and assessment of results. The loop is continuous and can move in both directions. That is why understanding and adapting to risk is a key financial management skill.

There is no shortage of good ideas in the public realm. There is equally no shortage of advocates for specific polices or courses of action. But there are never enough resources to get things done. Eventually, the "wants" will meet the "won'ts." Tradeoffs will be made. This is a fact of public administration life. Further, neither policy decisions, nor allocations of resources to support them, are made in isolation. There is a continual and fierce competition among departments of governments for both policy attention and resources. For any player in the public sector, it is vital both to have an understanding of how governments balance their objectives and allocate funds to them, and to know both the formal and informal decision-making systems for budgetary allocation and reallocation. Succeeding within those systems is often a measure of one's capacity to obtain resources on behalf of a program or policy initiative. This does not mean that bigger budgets are an indicator of success. As we will see, being a successful financial manager – meaning manager of finances – also means being able to identify the risks in the environment that will affect achieving your objectives and to find internal resources to adapt to changing circumstances. It may also mean being able to reduce your budgets while sustaining program integrity – a tough challenge.

The challenge does not end there. Just getting the money is the first step. It has to be spent for the purposes intended according to the rules. Results have to be achieved. Accounts have to be rendered of both performance and compliance for the public policy good and for the resources themselves. There has to be a continuous refinement of the policy, public good, or program to make it more effective and efficient, which can involve resource reallocations and outright reductions. This, then, is the framework of financial management. **Figure 0.2** puts this framework in the context of public policy but also the core actions within financial management that support it.

Getting funds approved by whatever authorizing body to perform some measure of public good is the start of the financial-management cycle that this text examines. Not all public-sector managers need to be accountants to do their jobs. (This text will certainly not qualify you as one.) Nevertheless, effective management of funds requires an understanding of basic accounting language and tools.

All public-sector managers are financial managers to some degree. For instance, they may have direct authority and responsibility for spending funds, approving expenditures

2. *The Five Pillars of Effective Governance,* Centre for First Nations Governance, see http://fngovernance.org/publications

Figure 0.2
The Cycle of Public Policy and Financial Management

Plan, budget, cost, authorize
Funding Your Objectives
Control, monitor, adjust, reallocate
Achieving Your Objectives
Measuring Performance against Objectives and Retooling
Report, account, audit, evaluate, recost, reallocate

and contracts, being concerned with the policies that allocate them, or being responsible for monitoring their use from a range of perspectives, e.g., as the client or the organization, or in an external oversight role. Each of these roles in the delivery of public goods has a financial aspect.

There are tools we will look at so that managers at all levels within public-sector organizations can effectively spend and account for the resources they are responsible for. These tools include risk and accountability, accounting principles, program information and control mechanisms to ensure that the funds are being spent, properly monitored, and accounted for.

Funds do not spend themselves. Decisions must be made and actions taken. Procedures must be put in place to make sure that spending happens. Cost controls and the avoidance of over-expenditure through effective management practices are vital aspects of financial management. Effective control requires an understanding of how to build and use financial reports even if you do not do this yourself. A key relationship here is that between the practitioner and her financial advisor. All the time public policy is being implemented in any organization, there are financial practices in place to make sure that funds are accounted for. Much of this is technical in nature, although the effective financial manager must understand the basis for the accounting, even though she will not be doing that work. It also puts financial management squarely into the realm of human relations, organizational behaviour, interpersonal relations, deal-making, and deal-breaking. Financial management is not just about numbers. It is also about people. It requires a constant eye on the public and political implications of poor management of funds allotted.

Such managerial behaviours are all part of a cycle of control of public funds. The ability to demonstrate, in terms both of procedures and of results, that you are in control of your resources is essential to creating public confidence. Establishing such measures of management control that are consistent with risk, material importance, and clarity go to the heart of both internal and external accountability.

Accountability is integral to public-sector management. All public-sector organizations have both internal and external accountability mechanisms to both justify and control their funds. There are two key elements of public accountability:

- Funds are expended for the purposes for which they were budgeted.
- The manner in which they are spent follows legal rules set out to avoid fraud or misuse of public monies.

While the issue of control often centres on questions of misuse of funds, it is more complex than that. Control is a positive element of management that focuses on how the organization is achieving its goals, what variance it is seeing against plan and how to mitigate the risks that arise from that variance. Without control, it is impossible to deliver public goods and manage public funds. There is a reasonable expectation that financial results also bear some connection to program results. Thus, financial management is a part of the greater accountability to deliver on policy objectives. Financial information is often central to determining if those objectives have been met.

Accountability also has many internal-to-government dimensions. In measurement and evaluation, the issue of profit and loss is seldom material in assessing the performance of a public-sector institution, but the question of being within budget certainly is.

Financial information is of interest for other reasons. For example, the public, or the politicians representing them, will often be concerned with the equity issue. Did we get our share? Such debates and interests pervade public discourse. They find their substance in reported financial data.

In that context, financial information often serves as a surrogate for other performance data. Often non-financial performance data are unavailable. The expected program outcomes cannot be readily measured. Many governments do not do a good job of reporting on performance, and financial information is often the clearest data that come forward on a regular basis. That is changing, for the better.

This practice does not mean that financial information presents a full picture.

Although the accounting profession sets high standards for its work, there is also a tendency to treat all financial information as absolute. Think twice about that. However, as we shall see, issues of recognition and reporting cycles have to be understood in order to interpret financial information.

There is, then, a full circle of elements to financial management in the public sector. The size of the organization and the scope of its activities will dictate the degree to which this circle is complex or simple. Regardless of size, all agencies spend other people's money. They must do so effectively and efficiently and be prepared to answer for it at the end. This, then, is the framework that we will adopt for this text. It is illustrated in **Figure 0.3**. The organization of this text follows that framework.

Financial Management Is About People and Organizations

Too often financial management has been presented as objective and not affected by such matters as politics, power or culture. The reality is that it is very much about all of these things. Resources are managed within the operating culture of the organization. They are subject to all kinds of pressures. In the public sector, pressures include the general public wanting to know about how their taxes are being spent, the client with a program entitlement, the legislative auditor, the senior managers and political leadership, as well the employees who want to know if the budget will keep them in work and doing what they feel they are there to do. All have agendas. All interact. All want to affect outcomes.

Similarly, the interpretation of so-called objective information is always open to debate. Within this framework of financial management in the public sector, therefore, lies a recognition that games get played, that interpretations of financial events and decisions vary, and that many tensions are at play. That is why this text contains sections with such headings as **"The Budget Games that People Play"** as a frank recognition that financial management operates in a rich and human culture.

The in-year management of approved budgets receives considerable attention in this text for several reasons. First, little attention has been given to the managerial and organizational skills often needed to manage budgets within the fiscal year. Second, the process of managing a budget effectively is an important managerial skill, involving not just cash projections, but also judgements about how the organization will behave within the year and the risks it must mitigate. Third, in-year budget management is where financial and performance information meets organizational culture. Finally, the effective management of the budget plays a large role in ensuring that budget targets are met in terms of being spent effectively for the public good but are not overspent.

It would be impossible to cover fully all forms of financial management practice in all parts of the public sector in Canada. The objective of this text is to develop a broad understanding of the basic assumptions that come into play in managing public resources for both the student and the practitioner. Their applicability in specific circumstances

Figure 0.3
Public-Sector Financial Management Framework

will vary across the spectrum of public-sector organizations, so the examples are chosen to apply to different kinds of organizations.

For those who are not involved in the complexity of accounting processes or whose heads begin to spin when they see a report with charts and numbers, financial management can be frightening. But, as many students have recognized in considering whether or not to take a course in financial management, "This is something I know I have to understand." Indeed, this is true. One of the principal purposes of this text is to demystify financial management for students and public-sector managers. To that end, they do not have to become accountants. Rather, they need to understand the framework, see the principles at play, to develop some awareness of them, and in the end, use financial management as another tool of good governance.

Financial management is the application of wisdom, experience, and sound judgement using tools that you often do not fully understand but that, in the end, deliver what you need as a good public servant: the money you need to get the job done and the ability to use that money effectively while keeping yourself and your political masters out of jail, or worse, out of too many appearances before public accounts committees or the excessive and never (let's be honest here) happy attentions of your external auditors.

To that end, this Introduction will end with a discussion of just what is financial literacy, both in individual and organizational terms.

First Nations Financial Management: How This Text Relates to an Emerging Field

This text is ambitious enough to be relevant to all governments in Canada. That includes First Nations. Recognizing and respecting some major differences in culture, governance and resources, the basic principles, tools and

techniques of public sector financial management outlined here apply to First Nations. As with other governments, the user of this text is envisaged to be someone, be it a student or practitioner, who is not an expert in accounting or finance. Rather, it is designed for the government official who has to put together a policy and understand where the budget fits it, or who must manage a program to serve people in the community, managing a budget, forecasting changes and adapting to them.

The opportunities and challenges for First Nations to manage their resources to better meet their needs and establish their control of their communities have increased over the past decade. There are 634 First Nations within Canadian territory. They vary dramatically in size, financial capacity and governance capacity. As such, developments in the area of financial management vary among them. So too does their dependency on transfer payments from the federal government as their prime source of revenue. These transfer payments come with a number of conditions and reporting requirements from the federal government, some of them burdensome for First Nations. However, First Nations also have own-source revenue sources that vary from income from natural resource agreements, operation of various forms of tourist activities, income from joint ventures and local taxation of business.

First Nations are required by law to make audited consolidated financial statement public. However, this one requirement is built on traditional values of strong accountability to members, based on traditional, family- and community-based governance and decision making. Samples of First Nations financial accountability will be found in this text. Further, over the past decade, First Nations have come together to bring more leadership and resources to support First Nations' financial management capacity. First Nations, as governments, follow PSAB's accounting and financial reporting standards – Canadian Public Sector Accounting Standards. The First Nations Fiscal and Statistical Management Act, a piece of federal legislation that was proposed by First Nations themselves in 2005 provides for each First Nation government to enact a Financial Administration Law, similar to the kinds of legislation that the federal and provincial governments have enacted, generally called a Financial Administration Act. Over a third of First Nations have ascribed to this Act. In 2008, CPA Canada issued a report called ***Financial Reporting by First Nations*** to provide guidance on the delivery of financial services. Concurrent to this was the creation in the 2005 legislation of the First National Financial Management Board to support the development and implementation of good governance and financial practices. It developed the Financial Administration Law prototype and the Financial Management System Standards. These were first implemented by the Songhees Nation in 2009. It was also in this period that First Nations acquired the right to borrow from the First Nations Finance Authority, another creation of the 2005 legislation. In 2013, this Authority was given investment grade credit ratings. Strong borrower performance from First Nations made this possible.

This short history points to the growing strength in financial management in many First Nations. As they evolve towards greater self-determination, and as the financing relationship with the federal government moves away from the traditional transfer model of contributions agreements with onerous reporting relationships and detailed conditions, the challenge of effective financial management will grow, especially as First Nations across the country co-operate more fully in setting standards, improve their own accountabilities to their members and expand their own-source incomes through various activities.

There are very few differences between the financially literate public servant doing policy work or managing a client-centred program for the federal government in Winnipeg and a person in a similar role in Kahnawá:ke First Nation. Stresses, opportunities, history and context may vary quite a bit, but from the point of view of financial management, what is in this text applies equally and well.

Case Study in Building on Sound Financial Management

This story reinforces the words above. The Fisher River Cree Nation in Manitoba leveraged effective financial management to take control of its future to fund a new school. The path, recorded on the website of the First Nations Management Board (FMB), shows how the path of good financial management leads to results:

> On October 16, 2013, Fisher Nation enacted their Financial Administration Law (FAL). They gained their Financial Performance Certificate later that month, which allowed the Nation to become a borrowing member of the First Nations Finance Authority (FNFA).
>
> The real work started after enacting their FAL. In order to also achieve Financial Management System (FMS) Certification, Fisher River Cree Nation began working closely with the FMB staff to bring their FAL to life.

The FMB supported Fisher River Cree Nation's needs in a variety of ways, including:

- holding a conference with technical sessions on the Finance & Audit Committee, multi-year financial planning, risk assessment and policy development
- putting Fisher River in contact with other First Nations who have completed their FMS certification to share experiences and tools at the FMB's annual FMS conference
- providing ongoing tools, templates, sample policies, webinars, and working groups

The outcome

Fisher River Cree Nation achieved FMS Certification on October 27, 2017. The FMS Certification provides a range of benefits to Fisher River Cree Nation and its members, including

- transparency and accountability to Fisher River's members and future partners
- interest savings when borrowing through the FNFA
- building a reputation for strong governance and finance practices
- giving staff the skills and tools they need to better manage the Nation's finances
- long-term stability and continuity through agreed governance and finance practices
- better risk management
- The Nation obtained funding for a new school to house grades 7 to 12.[3]

What Is Financial Literacy for the Public Manager? The Answer Is A Two-Way Street[4]

"They Just Don't Get It"

In my teaching, as well as my interaction with senior government officials and commentators, I hear that there is a dearth of what they describe as financial literacy when it comes to sound public administration. This manifests itself in a number of ways, often reflecting the biases of the observer. For the senior government executive, there is a frustration that bright policy or operational public servants arrive in positions of responsibility poorly equipped to effectively manage their financial accountabilities. They rely too often on the school of hard knocks to pick up their financial skills. In addition, they fail to take cost and related financial implications into account when they make proposals. Most tellingly, they do not focus enough on cost reduction or cost avoidance.

When I teach public servants in our professional program, they often feel uncertain about their financial roles. Many times, they have no clear sense of where their roles begin and those of financial advisors end – not an easy question. They are uncertain about what level of financial expertise they need to get the job done. I can almost hear some of them asking "Am I there yet?" when it comes to understanding their financial role and executing it effectively. The reality, of course, is that they are never fully there as the demands of the work evolve and respond to the changing environment of public-sector financial management.

Too many times has the phrase, "They just don't get it" been applied by senior executives or financial experts to public-sector managers in general. What don't they get? The need for effective financial control. The need to reduce budgets. The need for good costing. The need to find new ways to finance projects. Often these deficiencies in individual managers are identified by the very people responsible for the strategic management of their department or agency who should be equipping them to "get it."

Financial literacy among public servants is vitally important for the effective and efficient delivery of public goods. Why? Because very few policy pronouncements mean much until we know what resources are going to go into making them happen. Further, as governments strive with competing demands for resources that are increasingly constrained, the impacts of changes in policy, delivery and finances become even more linked. We are also seeing a worthy focus on the intergenerational impact of policy decisions. The introduction of full accrual accounting and budgeting has reduced the capacity of government to make announcements today without taking into account the costs in the future. Sustainability is on the radar.

Finally, public reaction to financial missteps in government creates the notion that public-sector managers cannot manage the funds effectively – to get the work done, efficiently – best bang for the buck and properly – by the rules and with probity. The truth, seldom finding itself onto the headlines page of media websites, is that most govern-

3. See https://fnfmb.com/en/clients/stories/fisher-river-cree-nation
4. This section is based on an article I wrote for the *FMI*IGF Journal,* Spring, 2013.

ment officials do all three quite effectively. However, we cannot be naïve. These scandals raise again, in a different way, the question of what is enough financial literacy and "Are we there yet?"

But, is there a "there"? I am not sure that we could collectively agree on what financial literacy actually is and, even more daunting, when we have it. What I would like to do is offer some ideas about what financial literacy actually is for the public manager. My conclusion, however, is that financial literacy will only be achieved when we realize that it is a two-way street. To have a financially literate manager, you need a financially literate organization. This is more than just a matter of personal skills and training. In fact, it takes leadership and good governance too. So, for those top managers complaining about the financial prowess of their managers, tend to your own role in all this.

The Financially Literate Manager

Too much mystery surrounds this question. Financial literacy is not magic, just work. It certainly does not mean that line managers have to become financial experts. But they do have to become informed users of financial information, not just when it arrives as a regular report in their email or on the department's website, but throughout the policy and delivery processes.

Here are some of the characteristics of a financially literate public-sector manager. He or she:

- Understands how policy, delivery and costs are linked.
- Can identify the key assumptions behind numbers and link them to the policy or to the delivery environment.
- Applies a full life-cycle and secondary cost lens to recommendations.
- Can identify and, with experience, anticipate the cost impacts of events, changes, or those many small decisions that get made on a daily basis.
- Is aware of the financial framework within which his or her unit is working – budget limitations, opportunities, strategic directions.
- Understands his or her own budget, the components, the anticipated outputs it should produce, and how those numbers relate to the public policy good they are working to achieve.
- Can read and interpret well-presented financial reports and recognize badly produced reports.
- Can identify the kind of financial information he or she may need on a regular basis – generally built up over time and with inevitable trial and error– to do his or her job.
- Understands the necessary limitations and process requirements of financial practice, be it in procurement, in delegations, and in that very important area: financial probity.

At a practical level, an effective public manager needs to be able to:

- **Understand the lingo**: Some core terminology is essential. However, much of this terminology may have nuanced meaning in the particular operating culture of one organization.
- **Understand costs**: Managers have to spend time developing an understanding of cost factors in their operations. They have to understand the implications on their costs of changes to policy or practice. Even a tweak in procedure can have an impact on virtually any cost element. A minor policy shift seldom comes free of cost. A financially literate manager or policy advisor will understand this and try to determine the cost implications.
- **Read the reports:** This is best translated as being an intelligent user of financial information, be it costing for policy design or cash forecasts for the first quarter of the fiscal year.
- **Get clarity:** This may mean asking dumb questions. It may also mean pushing the point of understanding so that everyone is actually talking about the same thing. Financial advisors play a key role in developing this understanding and ensuring that there is, in reality, no such thing as a dumb question.
- **Marry up numbers on a page with what happens at the mission end of the organization:** A financially literate manager can see the link – or insist that it be clearly stated – between what may be for some just a bunch of numbers and the policy and operational impact.

What About the Financially Literate Organization?

There is a simple reality that only seems to present itself when things go wrong. You can have all the most financially literate people working for you but your organization itself does not act in a way that is financially literate. I do not mean corrupt, although that is a possible outcome of this deficiency. More often, it translates itself into managers saying: "Why bother? No one takes this financial stuff into account at the top. They are all policy wonks." Or "Who cares? It's all arbitrary and no amount of good control at our level will make any difference."

As I noted at the outset, I have heard too many senior managers bemoan the poor quality of financial savvy they see in their reports without also talking about their own behaviour. Financial literacy is both personal and organizational. One depends on the other. Go back to the "they just don't get it" mentality, which blames others for failing to appreciate the importance of public finances in policy and operational decisions. People pay attention to what their bosses pay attention to. Therefore, an organization without a culture that respects the financial side of the public good process – policy and execution – will never get it. Further, it is incumbent upon those organizations to set up elements of their governance that do the same. The organization must become financially literate.

Therefore, a financially literate organization is one that:

- Works hard to ensure integrated approaches to policy and delivery that takes into account costs and related financial implications.
- Establishes decision-making bodies that regularly review financial performance.
- Develops the means to communicate financial information widely throughout the organization.
- Makes financial literacy a core competency in developing its staff.
- Links financial performance to overall performance on objectives.
- Ensures that financial advisors are on the team, that their work is integrated, and that they, too, are held to account for achieving the organization's mission.
- Works hard to train managers and upcoming staff on financial issues.

Financial Literacy Is a Systemic Quality

Perhaps the final point with respect to the search for financial literacy is that it is not a matter of just having finance for non-financial managers training. The reality is that financial literacy means that financial matters are integrated into policy design and delivery. This is everyone's responsibility. This is not to denigrate such training, but the issue is a bit bigger than that. Well-trained line managers need to be supported by financial advisors who also get it with respect to the link between policy and finances, and the need for useful and relevant financial information. Financial advisors need to provide easily understood information on what might be, at times, complex information. These same managers need to know that being financially literate also means there is governance in place that actually uses the financial information and makes decisions based on it.

In the end, financial literacy is both personal and organizational. It is also both technique and art. Very few line managers aspire to be financial managers. But the reality is that they all are in modern terms. However, it is only through time and practice that an individual can be said to be financially literate.

I am offering a small checklist of questions that managers and their organizations can ask themselves. It may not fully answer the question "Are we there yet?" but might help with the trip.

Financial Literacy Checklist

For the Public Servant

- Do I understand the basis for our financial statements: accrual accounting, our external financial statements, funding sources, financing options?
- Do I understand what things cost? Can I apply adequate cost sensitivity analysis to possible changes in costs and predict their outcome?
- Do I understand how budgets are formulated where I work?
- Do I receive timely information on my financial performance in-year so that I can make adjustments and reallocate resources?
- Do I understand what resources I rely upon to get my job done but do not control?
- Am I aware of, and capable of, effectively using our procurement processes?
- Do I regularly include costs in proposals for change?
- Am I engaging with my financial advisor and is that person meeting my needs?
- Are the financial statements I see clear to me? Do they relate to what I do?
- If I have delegated authority, do I understand how I am to exercise it?
- Do I know the main operational and financial risks we are facing?
- Do I understand key financial concepts such as control, materiality?
- Do I link my responsibilities to the government's fiscal situation?

For the Public Organization

- Is there an effective integration of the financial functions into the policy, operations and decision-making activities of the organization?
- Do we as an organization generally understand the financial impact of the policy and execution decisions we make or recommend?

- Are costs well integrated into policy proposals that we consider?
- Do we provide good financial advice to the minister/council/board?
- Does the finance function contribute effective expertise and support to these activities?
- Do we do a good job of full costing of policy ideas?
- Do we have a good understanding of the costs of our operations and where there are cost sensitivities?
- Do we produce high quality financial information?
- Do we regularly review financial performance?
- Does our top management demonstrably lead this review process?
- Is the way we make decisions about budgets, cost proposals and in-year budget variance clearly understood within the organization?
- Do we reward good financial management? Is it part of the suite of key performance indicators for our managers?
- Do we assess our organizational financial performance?
- Do we link our financial information with our performance information?
- Is there a common financial management training package in place for our staff?

Section 1

The Public-Sector Financial Management Framework

Chapter 1

Financial Management in the Public-Sector Context

Chapter Objectives:

- Defining and describing the public sector in Canada
- Understanding the complexity of delivery of public-sector services and programs
- Understanding the scope of public-sector financial activity
- Outlining the unique characteristics of financial management in the public sector

Scope and Nature of the Public Sector

The public sector in Canada plays many roles in our lives. While the desirable overall size of government is always the subject of political debate, it has remained relatively stable in Canada over a long period of time, even with fluctuations in roles and responsibilities of different levels of government. As various waves of reform have passed through public administration, new forms of agencies, commissions, and public corporations have arisen, all different to some extent, but all contained under this large umbrella we call the public sector. Financial management has had to keep up to ensure that public funds remain just that and are accounted for in a transparent way.

For the purposes of this text, the term public sector is used in a broad sense. It encompasses:

- **Government**: Federal, provincial, territorial, and municipal
- **Government enterprises**: Crown corporations, legislative agencies, special operating arrangements, usually with a line of accountability to a political leader, be it a minister or municipal government
- **Broader public sector**: hospitals, schools and universities that derive most of their revenue from government, serve broad public objectives, and are supervised by law, regulation and active oversight by government.

While this definition describes the scope of the public sector, we also have to focus on the nature of the public sector. One approach is to say that it is not the private sector, i.e., businesses and privately owned firms, which has the unfortunate tendency of leading to a description of what the public sector does not have: profit motive, shareholders, etc. This can make the public sector look somewhat deficient in how it is structured and, in particular, how it approaches the management of its financial resources. One off-hand and generally inaccurate criticism of public-sector organizations is that the public sector has no regard for the bottom line. The bottom line referred to here is the profit or loss that drives most private-sector firms. This is expressed in purely financial terms: who is making money, and who is not?

The simple truth is that the public sector does not indeed have a single bottom line.[1] It has several, all being pursued at once. **Figure 1.1** outlines graphically the multiple bottom lines of government. In each case, these bottom lines come back to effective financial management. They also

1. A good source of insight into this thinking is T. W. Plumptre, *Beyond the Bottom Line: Management in Government* (Halifax: Institute for Research on Public Policy, 1988).

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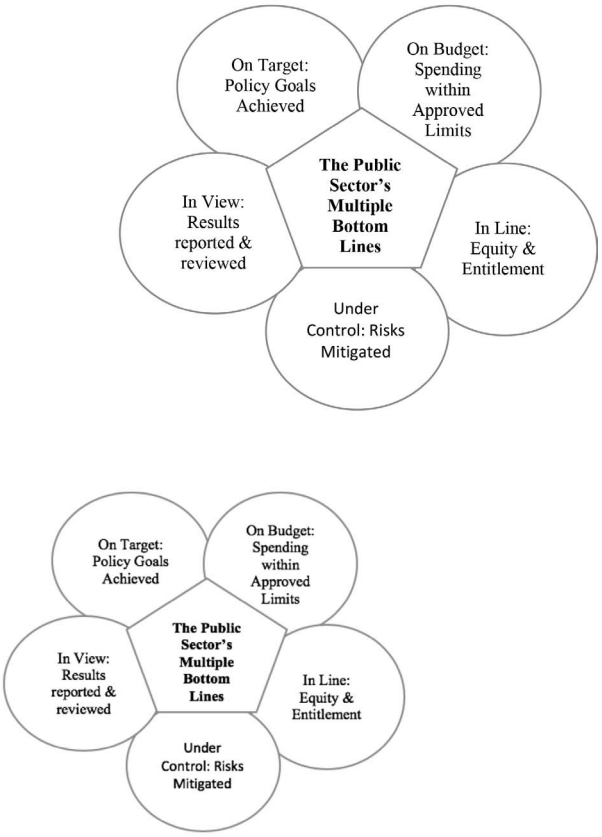
show just how tough managing public programs actually is. In each bottom line, there is a whole set of challenges:

- **On Target: Policy Achieved.** Very simply, did the funds spent achieve the policy objective for which they were intended? How was this measured and assessed? Financial information plays a part in answering this, but so, too, does performance information on targets and intended outputs and outcomes.
- **On Budget: Spending with Approved Limits.** Governments can only spend the money their legislature approves for them to spend. This crucial authority, going back to the *Magna Carta,* is at the heart of accountability and legal performance in government as well as its agencies. This means having the financial information to know if you are on budget or in danger of over-spending and, alternatively, not being able to spend according to plan in the time permitted (usually a fiscal year). Failure to spend can also be as problematic as failure to control spending.
- **Under Control: Risk Mitigated**. Is the program being delivered according to plans and authorities? Are risks that inevitably arise being mitigated in a way to ensure objectives are met? Risk is a core element of effective financial management as variances inevitably arise between the planned policy and funding and the real world.
- **In Line: Equity & Entitlement.** Governments serve all of the citizens, not just a select group of customers. Equity and fairness are often basic values so that citizens have the right to expect the same service no matter where they are in the country, province or municipality. Further, many of the programs involve legislated entitlements that require government to provide a service or payment as long as the citizen is eligible. This lack of discretion is deliberate, but it means that financial managers cannot just stop payments if funds are not available.
- **Under Scrutiny:** Transparency is the expected norm in government. There are multiple stakeholders, many of whom have the right to financial information of the program. There are checks and balances in which the recipients have confidence that make good reporting important. Finally, there are external audits and reviews to enforce this transparency.

Figure 1.1
Public-Sector Bottom Lines


On Target: Policy Goals Achieved
On Budget: Spending within Approved Limits
The Public Sector's Multiple Bottom Lines
In View: Results reported & reviewed
In Line: Equity & Entitlement
Under Control: Risks Mitigated
On Target: Policy Goals Achieved
On Budget: Spending within Approved Limits
The Public Sector's Multiple Bottom Lines
In View: Results reported & reviewed
In Line: Equity & Entitlement
Under Control: Risks Mitigated

Simplistic comparisons between the private and public sector are seldom helpful. Contrary to news headlines and clichéd perspectives, the public sector is far more complicated and difficult to manage than the private sector. The end results of public-sector activities can be varied and, at times, conflicting. Results are not always clearly articulated as governments pursue public policy goals in an attempt to achieve a measure of consensus, thereby leaving open, or vague, the actual results targeted. These goals are subject to continuous scrutiny and debate. Attributing responsibility for results can be difficult because it is often shared among many players. So, too, is blame when things go wrong.

How important is it to make a distinction between the public and private sectors? In terms of financial management, this distinction is very important. There are unique features in the public sector that will affect how resources are accounted for and managed, and how accountability is ultimately discharged. It is wrong to think that these distinctions are starkly drawn or that financial-management experience in the private sector has no relevance in the public sector. That experience has to be translated into the context outlined in Figure 1.1.

Similarly, many Crown corporations or special agencies of provincial governments are deliberately created by their governments to act on a commercial basis, even though ownership is retained by the government that created them. In many cases, they receive no direct funding from public sources. Their sources of funds are referred to as off-budget in that they are not provided in appropriations voted by the authorized legislature. They rely entirely on their own revenues arising from their operations through fees, charges for services or more commercial transactions such as the sales of goods. Their accounting systems therefore closely resemble those in the private sector.

The areas in which the public and private sectors are similar, and the public sector draws on private practices, are accounting systems, planning and budgetary tools, increasingly sophisticated financial management, and enterprise management systems (EMS).[2] The public sector is becoming more sophisticated in its financial management, generally following private-sector practices. Similarly, in accounting and budgeting systems, the public sector has now adopted for the accrual basis for accounting (see Chapter 3), a practice that has been common in the private sector for more than a century.

Size of Canada's Public Sector

There is no single number that adequately quantifies the public sector in Canada, especially in view of the considerable debate about what is considered public sector. In considering the scope of government activity, there are many ways to look at it:

- **Budgets:** This defines the amount of funds approved in each jurisdiction by its legislative authority, be it Parliament, a provincial legislature, a municipal council or the board of a hospital.
- **Number of Employees:** Governments as a whole employ a lot of people doing a lot of important activities in our communities.
- **Taxes, Fees and Charges**: Government uses a number of taxes to raise funds. The impact of these taxes is considerable on individual and economic decision-makers. It is also a subject of continuous political debate. It certainly raises the issue of getting results for those taxes levied. In some circumstances, the funds raised through these means may vary with economic conditions and therefore affect the ability of government to fund its programs.
- **Tax Expenditures:** These are various forms of tax relief or exemptions that reduce the amount of money taken in through the income tax system. They represent a considerable percentage of Gross Domestic Product (GDP), but do not enter the financial reporting system of government, either through its financial statements or internal controls.[3]

One issue is where to position the health and education sectors. For its purposes, Statistics Canada lists health and social service institutions, as well as universities, colleges, and vocational and trade institutions as squarely within its definition of government.[4] That is the right place, both in terms of considering the scope of government financial management and in accounting practice, to accurately reflect the reporting entity. This is described as the broader public sector. This is valid because most of the funding for these functions comes from government through transfer payments, a significant portion of the federal and provincial governments' expenditures. In addition, most health and educational facilities are undoubtedly publicly owned and governed. On the other hand, figures for the health and education sectors are also listed in Statistics Canada's information on the voluntary sector.[5] For our purposes, sorting out these methodological problems is not as important as an understanding of its relative extent and scope.

Individual managers will seldom be concerned with these measures. Their job is to manage a program, service or facility with the budget they have been given, with the rules established in their department, ministry or municipality and to be accountable for the results. They seldom set those rules, most of which are derived from some sort of financial administration law or policy. They seldom concern themselves with the taxation side of government, which is usually the responsibility of a central ministry such as finance or a council which set the local property tax rates to fund municipal programs. Perhaps a message to program managers and their financial advisors in the public sector is that some of the recommendations they make will have an impact on tax levels, fees and charges

2. The term *enterprise management system* (EMS) refers to complex software applications that support the operations of an organization, along with financial and, generally, human resource and inventory systems in a more or less integrated fashion.

3. The Macdonald-Laurier Institute estimates that tax expenditures represented over 10% of GDP in 2009. Information accessed through https://www.macdonaldlaurier.ca/size-of-government-in-canada/

4. Statistics Canada, "Public Sector Statistics," No. 68-213-XIE.

5. Statistics Canada, "Highlights of the National Survey of Nonprofit and Voluntary Organizations," No. 61-533-XPE.

and that these need to be well costed so that decision-makers can understand their impact.

The Employment Side of the Public Sector

According to Statistics Canada, in 2017, there were 3.7 million people who work for a local, provincial or federal government, for a government service or agency, a crown corporation, or a government funded establishment such as a school (including universities or hospitals.[6] The number of people employed is considerable. So, too, is the income earned by public servants. In itself, public service employment represents a major economic and distributional reality in this country. See Figure 1.2 below.

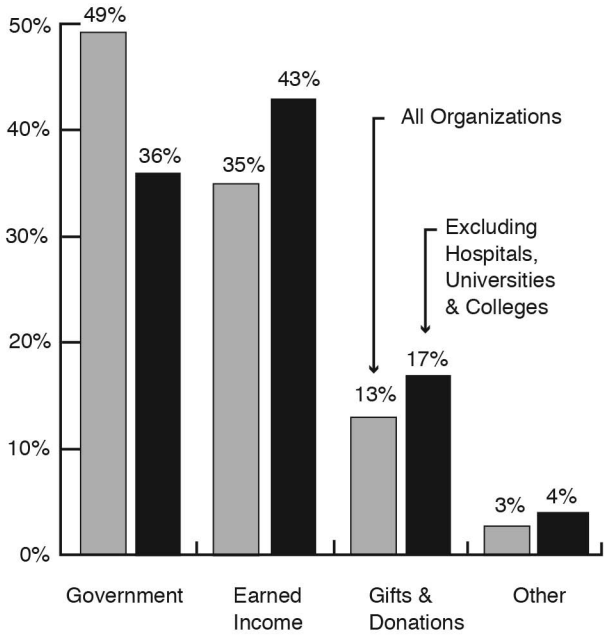
Figure 1.2
Public-Sector Earnings

	Wages and Salaries
	$ 000
Public sector	194,193,338
Federal general government	31,103,207
Provincial and territorial general government	23,198,296
Health and social service institutions, provincial and territorial	45,172,690
Universities, colleges, vocational and trade institutions, provincial and territorial	19,846,260
Local general government	21,161,298
Local school boards	33,713,366
Federal government business enterprises	5,349,386
Provincial and territorial government business enterprises	10,667,874
Local government business enterprises	3,981,059

The Cumulative Impact of Public-Sector Expenditures on Other Sectors: Volunteer and First Nations

The information outlined above speaks only to direct government employment. By that we mean the employment of individuals by governments, hospitals, educational facilities, and government enterprises. The reality is that many jobs in the voluntary and private sectors depend entirely on government funds. Similarly, through transfer payments, with one government to another or to other entities such as First Nations' governments, more people are employed with public funds. Governments contract for many services, supplies and infrastructure. Governments, as we shall see later, buy a lot of goods and services. Many Canadians who see themselves as working for a business are actually dependent on public funds through such contracts. A good example of the extent of this scope is the relative dependence of the voluntary sector on government funding, be it through direct contribution or, as is more often the case these days, through conditional contracts. **Imagine Canada,** a national advocacy group for the volunteer sector, published the following chart, showing sources of funds for the sector.

Figure 1.3
Voluntary-Sector Dependence on Government Funding



Source: Imagine Canada. See http://library.imaginecanada.ca/sector_research/statistics/nsnvo.

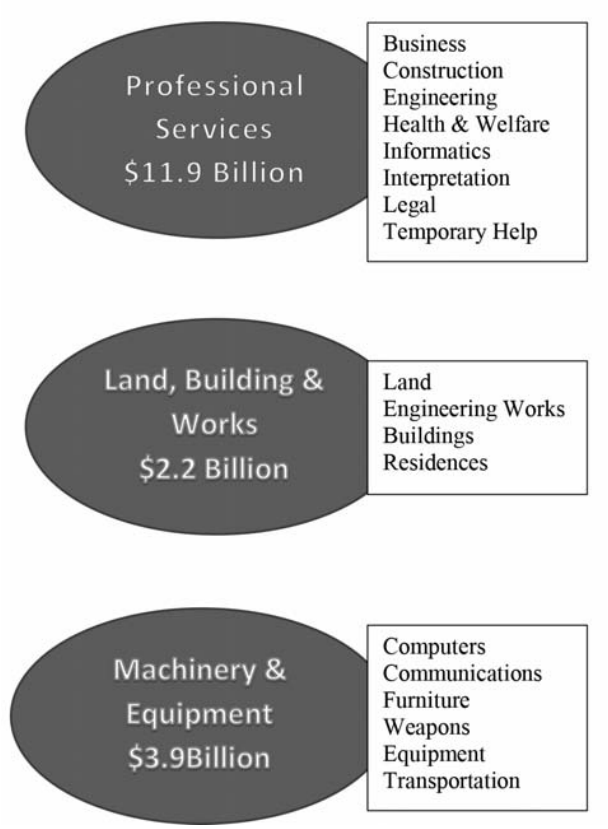
The Cumulative Impact of Public-Sector Expenditures on Other Sectors: Implications of Contracting and Buying in the Public Sector

All governments buy all kinds of goods and services from private companies. The range is immense. This creates employment in both the private and non-profit sectors. Although information about the extent of that employment is not gathered in a systematic fashion in this country, some governments do report on their contracting activities. For instance, the **Public Accounts of Canada**, an annual report of the Government of Canada of all its financial transactions, including the consolidated financial

6. Statistics Canada (2014a). Table 282-0012: Labour Force Survey Estimates (LFS), employment by class of worker, North American Industry Classification System (NAICS) and sex, annual (persons). Statistics Canada.

statement, summarized the federal government's buying activity in **Figure 1.4**.

Figure 1.4
What Governments Buy: Federal Government of Canada, Public Accounts, 2016–17



The expenditure of more than $17 billion in any budget is considerable. In this case, it is almost 30% of the total operating budget of the federal government at that time. In many instances, the contracts involve the employment of people doing work for the government. They may not be public servants, but they are doing public work.

The employment impact of public-sector expenditures goes well beyond the employment of public servants. Governments use contracting as a means of acquiring expertise, outsourcing work, or extending their workforces while appearing to contain the growth of the public service. In doing so, governments gain many advantages. They obtain expertise that it would be difficult to develop or pay for within traditional bureaucratic structures. They also obtain goods that the private sector is better equipped to build and provide to government. In addition, they avoid long-term employment commitments when their need is for shorter-term delivery of specialized services.

On the other hand, governments also have to manage and account for contracts. They must be able to financially monitor and account for the costs of contracts, their effectiveness, and their compliance with requirements. Governments must also manage and operate a publicly accessible bidding system, fairly weigh competing bids, and then administer contracts, often managing complex contractual relationships for large projects with high risk. This generally is done in-house as part of the cost of doing business. Ensuring a full accounting for the legitimate use of the funds expended is of major importance. So, too, is the need for effective cost controls and to contain and mitigate risk, especially for major capital projects such as new information systems or large construction projects, which cost a lot of money and will be in use for many years. This is why the use of the term *contracting-out* is so ill advised. Governments, when they administer contracts, assume an array of responsibilities as outlined above. They do not, in that process, relieve themselves of any responsibility for the final outcome. Accountability remains with government.

Contracting for goods and services is but one example of how financial management within the public sector is becoming more complex. As Lester Salamon, in ***The Tools of Government,*** points out when speaking of the various tools for delivering government programs:

> Indirect tools paradoxically require advance planning of far more operational details than is the case with more direct tools … all of this requires new processes and new skills that differ considerably from those of traditional government management.[7]

That is, the various tools of public good delivery in no way reduce the demand for effective financial management. In fact, they increase it.

Salamon[8] has identified a series of tools of public policy and service delivery. He defines a tool of public action as "an identifiable method through which collective action is

7. Lester M. Salamon, *The Tools of Government: A Guide to the New Governance*, Oxford University Press, 2002, ISBN: 9780195136654
8. Lester A. Salamon, "Rethinking Public Management: Third-Party Government and the Tools of Government Action," *Public Policy* 29, no. 1 (Summer, 1981), and Lester A. Salamon and Michael S. Lund, "The Tools Approach: Basic Analysis," in Lester A. Salamon, editor, *Beyond Privatization: The Tools of Government Action* (Washington: Urban Institute Press, 1989), 23–50.

structured to address a public problem."[9] Using his tools approach, he identifies a range of common tools and then, through the collaborative efforts of an impressive range of contributors, subjects each to a structured and detailed analysis. The tools examined are the following:

- Direct government
- Social regulation
- Economic regulation
- Contracting
- Grant
- Direct loan
- Loan guarantee
- Insurance
- Tax expenditure
- Fees, charges
- Liability law
- Government corporations
- Vouchers.

He concludes that, while discretion and flexibility in delivering services are important elements in a shift towards indirect government, government remains accountable for both the policy and delivery of such services:

> How to square these new approaches with the more traditional procedural safeguards of administrative law, however, is still far from settled, leaving administrators and courts alike significantly adrift.[10]

It can be argued, however, that administrators are not adrift or without guidance, especially when it comes to their financial responsibilities in an era that emphasizes more and varied delivery options. In circumstances where delivery is distributed, the risk of fraud and misuse of funds increases. So, too, is the risk of failure to achieve the program and policy outcomes in a timely manner. These risks challenge our financial management capacity. Similarly, administrators have to understand the financial records and statements of the various delivery agents in order to assure themselves that they are receiving fair representation in financial reporting. What this era is creating is the need for public managers with financial responsibilities to be smart buyers of goods and services.

9. Salamon, The Tools of Government.
10. Ibid., 605.

Expenditures and Revenues: What Governments Spend Money on and How They Pay for It

Measuring the amount of money that governments spend is fairly straightforward. The Public Accounts and summary financial statements of virtually all governments are readily available, and Statistics Canada provides this material in both graphic and tabular form. The full impact is only fully understood when we look at all governments, their agencies and the broader public sector. The provinces, territorial and local governments combined actually spend more money than the federal government. The healthcare sector is huge. In addition, in Canada, one has to take into account the impact of intergovernmental fiscal transfers. These are funds, in the form of either general or program-specific grants, that are transferred from one level of government to another.

Figure 1.5 outlines the scope and sources of governmental expenditures and revenues from fiscal years 2005–2009. Since this chart covers all governmental activities at all levels of government, it is difficult at times to determine which level is spending what amounts. Charts that break this down to provide such information are available through Statistics Canada's website, although some overall factors relevant to financial management bear consideration. The point here is to look at the cumulative impact.

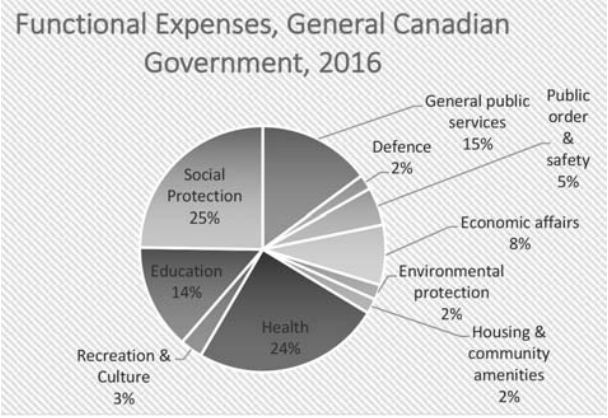
In Canada there is a poor match between actual spending responsibilities and the ability to raise funds within a specific level of government, and between governments as well. While the federal government has certain spending requirements, it has taxation capacity well beyond those requirements. At the other extreme, local governments generally have very limited and inflexible taxation powers, using mainly property taxation, while growth of their costs has been much the same as in other levels of government. In Canada, this is referred to as the fiscal imbalance.[11] Governments dispute the extent of this imbalance, and some even suggest it does not exist. It is not surprising that it is the government with the greatest revenue flexibility – the federal government – that minimizes this issue. The ones with the least flexibility, notably the provinces and local governments, are most likely to advance such claims.

11. An excellent review of the history and context of the fiscal imbalance issue in Canada can be found in Robert Gagne and Janice Gross Stein's report for the Council of the Federation, entitled, "Reconciling the Irreconcilable: Addressing Canada's fiscal imbalance," retrieved from http://www.councilof thefederation.ca/pdfs/Report_Fiscalim_Mar3106.pdf

Figure 1.5
Per Capita Revenue for Federal, Provincial-Territorial and Local Governments, Canada, 2016

Taxes	Per Capita
Taxes on individuals - income, capital gains	6,729
Taxes on corporations	2,208
Taxes on property	1,950
Taxes on goods & services	4,449
Other taxes	483
Total Taxes per capita	15,819
Social contributions	1,009
Property Income	889
Sales of goods & services	2,074
Miscellaneous revenue	302
Total Revenue per capital	20,093

Compensation of employees	6,645
Use of goods and services	4,390
Consumption of fixed capital	1,831
Interest expense	1,583
Subsidies	565
Grants	394
Social benefits	3,971
Other	1,211
Total Expenses per capita	20,590



In reality, while the power to tax may be shared, the federal government has control over the most lucrative taxing powers. Provinces are loath to raise personal and corporate taxes because of the potential political consequences even though they can. On the other hand, provinces have access to natural resource royalties that can, in robust economic times, bring high yields. As one way to meet some of the shortfalls in provincial needs, but still retain its control over taxation, the federal government uses its taxation ability to effect policy objectives through specific transfers to provinces and territories for program purposes. It also has established a system of equalization payments for provinces to create a level playing field for basic services across the country.

The result of a complex series of policy negotiations involving both equalization and program-specific transfers is that a significant portion of the federal government's budget involves the movement of monies to the provinces. The trend in this movement is shown below in **Figure 1.6**. Included in this chart are all federal government transfers, including those to people directly through a variety of social support programs. **Figure 1.7** lists the key policy tools that are used in the federal-provincial transfer process.

Figure 1.6
Where the Transfers Go: Federal Government Transfer Payments, Public Accounts, 2016–17

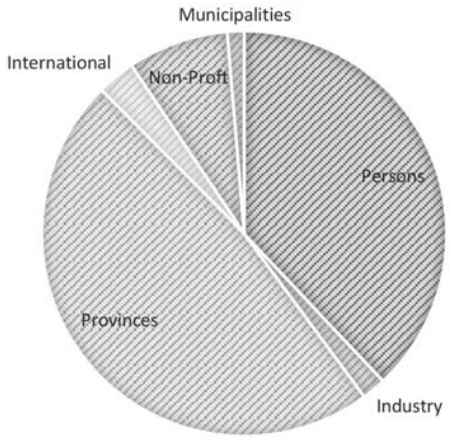


Figure 1.7
Major Federal Provincial and Territorial Transfer Programs

Major Federal Provincial and Territorial Transfer Programs Public Accounts, 2012–13 Millions of Dollars	
Canada Health Transfer	25,569
Canada Social Transfer	11,861
Equalization	15,423
Offshore Accords	458
Territorial Formula Financing	3,111
Other – Transition, Special Adjustments	680
Direct Targeted Support – Hospital Wait Times, Labour Market Adjustment	750
Total	60,851
Per Capita Allocation	1,747

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
				(millions of dollars)				
Major Transfers								
Canada Health Transfer[I]	20,310	20,140	21,729	22,768	23,987	25,426	26,952	28,569
Canada Social Transfer[I]	8,415	8,500	9,857	10,560	10,865	11,186	11,522	11,861
Children			1,100	1,100	1,133	1,167	1,202	1,238
Post-Secondary Education			2,435	3,235	3,332	3,432	3,535	3,641
Social Programs			6,202	6,202	6,388	6,579	6,777	6,980
Equalization[II]	10,907	11,535	12,925	13,462	14,185	14,372	14,659	15,423
Offshore Accords[III]	219	386	563	663	645	869	787	458
Territorial Formula Financing[IV]	2,058	2,118	2,279	2,313	2,498	2,664	2,876	3,111
Other Payments[V]					563	668	952	680
Subtotal	*41,909*	42,680	47,352	49,765	52,743	55,185	57,747	60,101
Change from 2005–06		+771	+5,443	+7,856	+10,835	+13,276	+15,838	+18,192
Direct Targeted Support								
Labour Market Training Funding				500	500	500	500	500
Wait Times Reduction	625	1,200	1,200	600	250	250	250	250
Subtotal	*625*	1,200	1,200	1,100	750	750	750	750
Total – Federal Support	**42,534**	43,880	48,552	50,865	53,494	55,935	58,497	60,851
Per Capita Allocation (dollars)	1,321	1,348	1,476	1,529	1,588	1,641	1,698	1,747

See explanatory notes

[I] CHT/CST include transition protection payments as of 2007–08. CST also includes $31.9 million from Budget 2008 transition protection payments to Saskatchewan and Nunavut notionally allocated over five and three years respectively beginning in 2008–09.

[II] Includes payments and additional amounts. Also includes 2009–10 transitional Equalization protection to Nova Scotia and Manitoba. From 2007–08 onward, reflects the 2007 formula for all provinces except Newfoundland and Labrador (NL) which remained under the previous Equalization formula until 2010-11, when NL made the election to enter into the 2007 Equalization formula.

[III] Includes cash amounts from the 1985 and 1986 Accords and cash and notional amounts from the 2005 Accords. Also includes $83 million in 2011–12 and $312 million in 2012–13 in cumulative best-of payments to Nova Scotia.

[IV] Includes payments, additional amounts and data revisions.

[V] Other payments include the 2009–10 transition adjustment payment to Nova Scotia ($74 million), the separate payments to Ontario for 2009–10 ($489 million) and for 2010–11 ($142 million) to ensure it receives the same per capita CHT cash support as other Equalization-receiving provinces.

Other payments also include Total Transfer Protection (TTP) provided in 2010–11 ($525 million), 2011–12 ($952 million) and 2012–13 ($680 million) ensuring that a province's total major transfers in one of these years are no lower than in the prior year. For the purpose of calculating TTP, total major transfers comprise Equalization, CHT, CST and prior year TTP. One-time recoverable payments to Ontario ($150 million) and Prince Edward Island ($1 million) for 2011–12 not included.

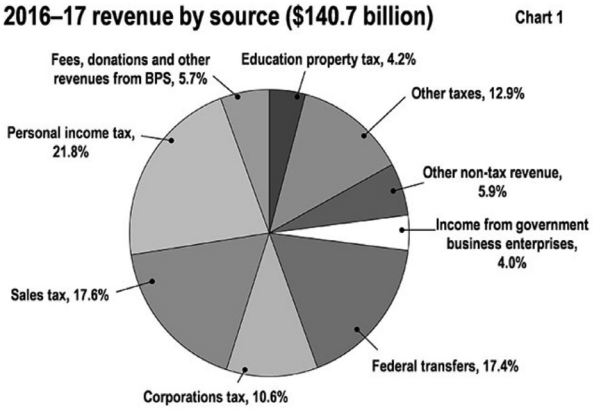
From a financial management perspective, these transfers represent interesting accounting challenges. For every transfer from one level of government, the financial statements record an expenditure for one government and a revenue for the other. How this is done will depend on what conditions are associated with the individual transfer. In some cases – equalization, for instance – provinces receive funds into general revenue as part of their consolidated revenue fund and are free to use the funds as they choose. In others, where program-specific conditions apply, a more detailed accounting to ensure that the funds were spent for the purposes agreed upon may be necessary. **Figure 1.8** shows that Ontario in 2016–17 received 17.4% of its revenue from the federal government. Of note is the fact that much of Ontario's spending is also in the form of transfer payments to municipalities, school boards, regional health authorities and individuals.

Transfer payments play an important role in the budget processes of virtually all governments. Of course, these arrangements are also part of the fabric of Canada's federal system. The impact on policy and budget decisions is great. From the perspective of the individual program manager, there are a number of implications. For instance, a targeted transfer payment may require additional reporting to the transferring government. We see this in the instance of First Nations, where the reporting requirements impose an excessive administrative burden even though they are meant to ensure greater accountability. As program is added to program, this additional reporting requirement reduces the capacity of the First Nations administrators to determine their own priorities. In general, however, the nature and number of transfer payments will not affect the individual manager as most funding for programs comes through the decisions of central agencies such as a Department of Finance or Management/Treasury Board.

A Closer Look at Government Expenditures: What One Government Spends, Collects in Revenue, and How it Spends

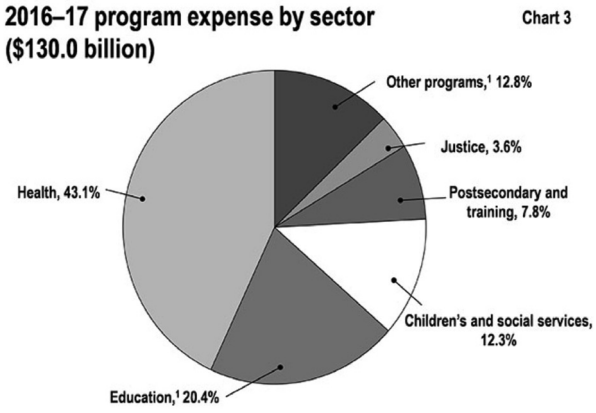
We have different levels of government that provide different goods and services and collect revenues in different ways. The Public Accounts of the federal and provincial governments and annual financial reports of municipalities, all of which have the core financial statements necessary for external accountability and reporting, document both in great detail. For the purposes of illustration, we will look at one province to show where money is collected, spent, and on what. **Figure 1.8** shows the revenue by source for the Government of Ontario, 2016–17. Note that taxation is a major part of the revenue of this government. No surprise there. But note also that almost 20% of revenue is from transfer from the federal government.

Figure 1.8
Revenue by Source, Province of Ontario, 2016–17


2016–17 revenue by source ($140.7 billion)
Chart 1
Fees, donations and other revenues from BPS, 5.7%
Education property tax, 4.2%
Other taxes, 12.9%
Personal income tax, 21.8%
Other non-tax revenue, 5.9%
Income from government business enterprises, 4.0%
Sales tax, 17.6%
Federal transfers, 17.4%
Corporations tax, 10.6%

Now, look at what kinds of activities or programs are funded by this revenue. **Figure 1.9** outlines the government's expenditures by sector or program area.

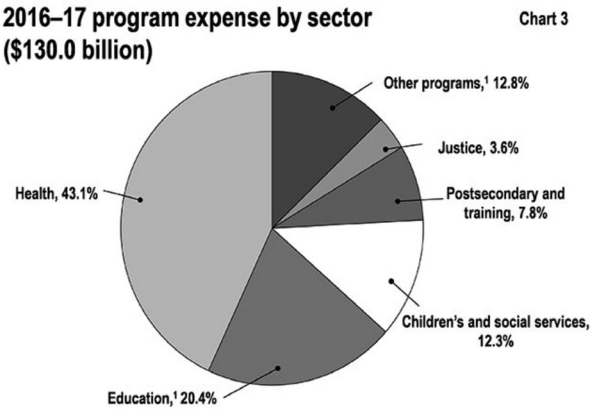
Figure 1.9
Expenditures by Program Sector, Province of Ontario, 2016–17



Anyone familiar with provincial governments would not be surprised by this distribution. Health clearly occupies a major focus for all provincial governments. When we look at budgets, we will see that they can be constructed to reflect this programmatic structure to answer the question, "What are you spending my tax dollars on?" But there is another perspective that will bring us closer to the public

sector manager – the costing of the inputs, the resources needed to deliver these programs. **Figure 1.10** addresses the question, "What are you doing with my tax money?"

Figure 1.10
Expenditures by Input Type



These expenditure types are instructive in that they form the inputs governments need to accomplish their objectives. First, so much of what government does involves having the people to deliver programs. In general, salary dollars will occupy the major share of most governments' expenditures. The model of the permanent public service delivering programs is still alive in this country. Second, note, however, the degree to which the province delivers its program through transfer payments. The major recipients of these are the education and health sectors. In both instances, governments deliver through agencies of the broader public sector, e.g., school boards, universities, regional health authorities and specialized health delivery agencies. Why is this particular chart useful for the program manager? After all, it does not indicate what these inputs are supposed to do. However, assuming that a program manager is capable and knowledgeable, i.e., has an established program with objectives and outputs defined, this chart tells the manager what she has to work with. Of course, taken at the government-wide level, this lacks the specific number that any manager will want to have. But, as the process of budgeting moves down from the government-wide level to department to program to operating unit, these inputs, or line items as we will see when discussing budget architecture, take on a very important meaning for the manager answering the all-important question, "What is my budget for the coming year? How many staff do I have? How many resources to support programs?"

These three charts confirm that governments are concerned with revenue, program expenditures and what they spend money on. Further, in the larger public sector context, the effective management of resources through the budgeting, implementation and accountability stages, can become quite complicated. We now turn to the qualitative elements of the public sector context that will mold financial management.

The Qualitative Elements that Make Financial Management Different in the Public Sector

This brief survey of the extent of financial activity in the public sector shows how complex and varied it can be. It also shows the importance of managing these funds well. Public services range from national defence to disaster management to sustaining historical locations to providing meals on wheels to senior citizens. Public funds support more than government activities to include the broader public sector, both for and not for profit delivery agents and First Nations governments across the country. Similarly, the organizational structures to deliver those services also vary dramatically. It would be a mistake to think of the traditional government sector with specialized departments or ministries as the sole image of the public sector.

This section sets out in this context what is unique about the public sector and, for the purposes of this text, what impact that will have on the management of financial resources. The *CPA Public Sector Accounting Handbook*, created and maintained by Canada's accounting standard-setting body, the Public Service Accounting Board, provides some useful ways of looking at financial management in the public sector.[12] PSAB guidance will also inform the discussion of accounting principles in **Chapter 3. The Accounting Framework for Financial Management.**

Governments Serve Multiple Objectives beyond the Profit Motive

The first element is the explicit absence of a profit motive and the attribution of the public good motive. There is a distinction to be drawn between making a profit and earning money to fund programs. The essence of this distinction is that the profit, while readily defined as the excess of earnings over costs and therefore applicable in many public sector organizations, goes to shareholders

12. The work of these agencies is publicly available through the exposure drafts that they set out for all to see. For the PSAB, see http://www.frascanada.ca/public sector-accounting-board/index.aspx and for the IFAC, the main site is http://www.ifac.org/

or owners of the organizations for their private purposes. Whatever a private enterprise does, its first objective is to be profitable. Public-sector profits (often called margin) are returned to the consolidated revenue fund of the government or held in specialized reserves, to be used strictly for some public purpose, not personal gain. Just occasionally, they are returned to the taxpayers by way of reductions in taxes or fees.

Refer back to Figure 1.1 and the discussion of the multiple bottom lines that the public sector uses to assess its performance. This defining element sets out the purpose of the organization itself. While it is difficult to generalize, most public sector organizations exist to meet one or all of the following objectives:

- **On target: To achieve a public good.** A public good is one that applies to all citizens or those included in the mandate of the program or policy. Further, it is often indivisible among individuals as consumers but applicable to society as a whole, e.g., public safety, fairness, defence. The concept of what should be considered a public good is open to political debate, but the key point here is that the raison d'être of many public entities is to provide such things as policies and regulations designed to achieve a public good. This challenges the program manager to balance program goals with financial responsibility, to understand the costs of a program and to be able to link the resources with results.
- **On target and under control: Public-sector organizations are measured by the achievement of their goals, not the profit they make**. In fact, many public-sector organizations that failed to spend their budgets have faced criticism from some part of society that felt that needs were left unmet or the organization was deficient in delivering on its objectives. The program manager has to control the budget she is given to ensure it is spent for the purposes intended, that the needs it is intended to address are, in fact, addressed and that funds flow to the entitled recipients. Leaving budget unspent when there is a need or unmet eligibility is not good management.
- **Under control: To provide goods and services to the public or to special categories of the public**. The range of these within the public sector is impressive. Which goods and services are delivered in the private sector, and which are provided in the public sector, is a matter of political ideology. Health care, for example, is treated by Canada as a public good, while the United States sees it as a mixed good with both public and private elements. More careful examination will show that this distinction is really a matter of degree, not an absolute one. For instance, in Canada, many health-related services, such as most dental services, are not public at all. Similarly, most family doctors are private operators who happen to derive most of their income from public insurance.
- **In line: To redistribute wealth**. There are different ways of doing so, from social assistance to intergovernmental transfers based on equalization formulae. The degree of redistribution is subject to political decisions deriving from varying views of the state and its role. However, redistribution is not simply a matter of transferring from the rich to the poor. It can also be regional and collective in its nature. For instance, major economic stimulus packages have an important element of redistribution.

Risk and Its Mitigation and Management Are Central to the Public Sector

It can be argued that governments are the holders of a vast array of residual risks that cannot be assumed by others or insured against. This would include natural disasters, economic swings and, increasingly, acts of terrorism of an unforeseen nature. Therefore, even with the best of plans and budgets, governments may have to intervene with resources in short order, drawing upon their vast capacity to do so, but remaining answerable for the use of those resources after their mobilization.

In addition, managerial risks of not achieving objectives because of changes in circumstances, costs, or unknown factors is a constant reality in government. Managing policy and program areas that are inherently risky means that program managers have to develop risk awareness, identification and mitigation skills that are constantly in play. In spite of the mythology that governments are risk averse, the opposite is closer to the truth. They manage in a high risk environment that demands adaptation to change, innovation and the rapid redeployment to attention and resources in short notice.

For this reason, we will be visiting the issue of risk as part of our setting the financial management framework in the next chapter.

With Great Power Comes Higher Levels of Both Internal and External Accountability

All government entities derive their power to act as well as responsibility to do so from an elected authority. Even government agencies, often created to operate at arm's

length from normal government operations and possibly in a quasi-commercial manner, have a line that goes back to the act, regulation or order that created it. However, with that power and responsibility comes great accountability. Public resources are being used. These come from the citizens. A myriad of legislated requirements, financial and operational reporting standards, openness to scrutiny by the public and elected officials, ensure that there is a high standard of accountability in the public sector. This highlights the importance of sound financial reporting as part of that infrastructure.

It is also one of those elements of financial management in the public sector that molds the character and nature of that management. Accountability, as will be discussed in the next chapter, is diverse and multi-layered. On the financial side there are a number of types of accountability for funds:

- **Public policy**: Are they spent for an appropriate use?
- **Allocation**: Are funds allocated for the stated purpose?
- **Process**: Are the funds spent according to the rules that apply?
- **Equity**: Are funds distributed fairly and equitably?
- **Outputs or outcomes**: Did the funds achieve the intended results?
- **Accounting**: Can the funds be traced and identified?
- **Efficiency**: Were the funds spent in the lowest-cost way?
- **External review or audit**: Can others assess the financial information of the organization?

Government Financial Management Operations Are Governed by Legislation

This means much more than the fact that all organizations must obey the law. For the most part, at all levels of government and well extended into what is known as the broader public sector (hospitals, school boards, government agencies), the form and substance of how all elements of financial management will be carried are governed by legislated and regulated formatting, reporting and standards requirements. External financial reporting has to be consistent and comparable. Further, most governments set out rules for acquiring goods and services, limits to how funds can be used and a series of reporting, auditing and evaluation requirements. Compliance must be not only to the objectives of the public expenditure, but to requirements of form designed to assure transparency and fairness.

The Importance of the Budget

As we will see in subsequent chapters, a budget is a plan for expenditure and revenues in a future period. However, in the public sector, it takes on a much higher level of significance than in the private sector. It is a key tool for financial management and control. Its approval by the legislature or council represents the authority by public organizations to spend. It also represents a firm limit on what can be spent. The spending that it authorizes makes up, in aggregate, a significant part of the policy framework of the government. Governments seem to have an inherent fondness for making aspirational statements of policy intent. The reality is that those aspirations remain just that until a budget puts money on the table to deliver.

The budget serves as the first point of both internal and external accountability. Did the entity remain within its budget? Did it spend the money for the purposes voted? Did it provide accurate financial accounting of how the budget was spent? These are simple but key questions of public-sector accountability.

Lack of Equity Ownership/Reality of Collective Ownership

Public-sector organizations do not act in a way to render profit to individual owners or to grow their enterprises for the benefit of individuals. Rather, they manage their resources, received either from such collective revenue sources as taxation or through legislative authority to charge rates or collect fees. In turn, they use them for the public good, not the individual benefit of a shareholder.

Government Capital Spending Will Focus on a Range of Policy Benefits Rather than Only the Efficiency of the Operation or Lowest Cost

The CPA Canada Public Sector Accounting *Handbook* makes the point that the end product of most capital expenditure (buying buildings, acquiring land, buying equipment, construction and maintenance) in the public sector is not financial, i.e., it is not to increase earnings and, hopefully, profits. This means, for instance, that the Return on Investment model of assessing capital projects can be a limited tool in the public sector. That does not mean that such models cannot and should not be used, especially in the project-planning phase. But, as with many ways of assessing government spending, it is very seldom that a single measure applies.

Many capital projects and investments made by governments have both redistributional and social purposes. One

Canadian example is regional economic development. Various governments over the past fifty years have tried a range of capital construction and infrastructure programs to ensure that poorer, often rural, parts of the country received additional economic benefits, usually in the form of investments in capital infrastructure.

From a financial-management perspective, achieving these goals must also go hand in hand with sound project design, sound financial management of the project, and a capacity to evaluate it afterwards. In other words, the financial-management considerations must also be an important aspect of the goals that are to be achieved.

The Principal Source of Revenue for Governments Is Taxation

Governments have the power to compel people to pay taxes, pay fees for services, charges and special payments. In some cases, the fee is for a service rendered to an individual. However, in general, taxation does not mean that there is an equal exchange of goods and services for the taxes paid. You don't get the same level of public services as the taxes you pay.

While the public sector secures revenue to achieve a known set of goals, that income is not tied to any one specific goal. Rather, funds are combined into a consolidated revenue fund and subjected to a decision-making process, generally known as the budget cycle, that distributes these funds across a range of activities. This is what we know as the budgetary process, which is dealt with in Chapters 4 through 7.

Consolidation of revenues removes the capacity of the individual taxpayer to act like a consumer when it comes to paying for public goods. An important principle is that public goods are equally available to all citizens and are not for private purchase. This changes somewhat when fees and charges are applied to government programs and services. In such instances, there is certainly an element of consumer choice, but the basic principle stands: the ultimate distribution of funds is based on policy and political choice, not consumer choice.

Governments sometimes choose to deviate from this concept of consolidation of funds. Government can create special funds or enable public-sector organizations to receive and use funds on an exclusive basis. For example, all revenues that Canada Post receives from the sale of its services are held and managed by that organization and accounted for in a separate manner. They never enter the federal government's consolidated revenue fund, which is the central fund that receives general taxation and then disburses it among various activities within the government.

Nonetheless, the general principle stands and is an important one. Taxation applies to the entire population. The capacity of the public-sector organization to distribute its funds according to its policy requirements is important. One of the challenges in public-sector financial accounting is to ensure that all funds are accounted for and that taxpayers know their money was spent wisely.

Governments Hold Assets Acquired in the Right of the Crown

This principle applies to the government side of the public sector but can extend into the broader public sector such as health and education. For all, the public-good value of the assets may far outweigh a market-based valuation or resale value of the assets. In some cases of such assets, the purposes for holding such an asset render its market value marginal in calculating its future uses. Similarly, the public sector often holds assets that have lost their value for their original public-policy purposes. Perhaps one the best examples of this would be railway lands in urban areas. After many years of abandoning rail lines as a result of operational and economic changes, governments realized that they held valuable landholdings that were no longer needed. Because they had lost their original public-good objectives, these could, then, be readily sold.

Governments also hold assets that have no market value but are of great worth in terms of public interest. Historical properties are a good example of this. There is no need to place a market value on these assets as there is no intention of ever disposing of them. A good example is the many war memorials maintained at government expense across the country.

Governments Operate in a Non-Competitive Environment

This principle from the *CPA Public Sector Accounting Handbook* seems to contrast the monopolistic powers of government with the free-market nature of the private sector. The reality is certainly less clear. In general, market mechanisms cannot apply to most public-sector goods. Hence, competition based solely on price, supply, and demand do not work effectively in this much more complex environment. In fact, they distort many of the redistribution and equity objectives that public-sector organizations have. Financial managers therefore cannot rely solely on market-pricing mechanisms to determine

value. This challenges program mangers when they have to justify the costs of the services they manage or to find ways to reduce costs.

For the most part, the public goods that the public sector produces are not ones that the private sector would normally produce in a price-driven competitive market. That does not mean that the private and nonprofit sectors cannot deliver these goods. In such instances, the public sector or government becomes a buyer of such products and services. As already noted, the use of contracting for the provision of services is growing in the public sector. A distinction has to be made between the delivery of public goods on the one hand and the accountability and ownership of the good itself on the other. In that sense, the public sector remains accountable and responsible for the services it buys.

In addition, as part of the many changes in government management over the past twenty-five years,[13] some governments have introduced internal competition for the delivery of services, introducing private-sector pricing and permitting both private- and public-sector delivery organizations to compete with each other for the public good that they seek to purchase. There are also many public-sector functions that can move into the market environment. An example of that is the various decisions that provincial governments have made with the respect to the 2018 legalization of marijuana, some selling through publicly owned agents and some allowing private-sector sales. In both instances, however, the government remains the regulatory force.

Governments Have Debt Capacities Unparalleled by Most Other Organizations

While both the federal government and the provinces have borrowing powers, provincial legislation generally limits municipalities and the health and education sectors in the extent to which they can borrow. Both the senior levels have rich and diverse tax bases. As such, they can alter their tax structures, i.e., raise taxes to pay for debt and the cost of debt. Municipalities have limited tax bases, centred mostly on property taxes, and so their capacity to carry debt loads is severely limited. For the health and education sector, the constraints are even greater. The transfer payments outlined above are one means of addressing this taxing inequality.

The principal contrast here, however, is between the broader public sector and the private sector. The constraints on borrowing for a business are limited to its ability to pay for the debt and the reliance that it would remain a going concern, from the perspective of the lender, not the borrower. Here the larger governments in the public sector are considerably less constrained in formal, legal terms. However, as we have seen over the past decade, the accumulation of debt loads by government and the cost of carrying those loads can become matters of urgent public-policy concern.

Other Factors That Affect Public-Sector Financial Management

The characteristics listed above, based on the PSAB framework, provide a fairly complete picture of the public-sector financial landscape. Added to this framework are a series of further characteristics that, taken together, provide a full picture of financial management in the public sector.

The following are some of these characteristics to consider.

- **A Mix of Criteria:** As noted, governments tend to have multiple goals, but also multiple stakeholders with different views of what the desired public good is. For instance, in the area of public safety and policing, a variety of interests are at play at any time: victims, neighbourhoods, offenders, the courts, other police services, and interest groups, to name just a few. While many factors also come into play when decisions are made in the private sector, it is how the action will ultimately affect the bottom line of financial profit, in both the short and the long term, that is the criterion that must be met. In contrast, a government organization may debate a course of action that must balance a number of objectives: impact on clients, impact on staff and staffing, potential for funding sources, priority of one area over another, etc. For government, the use of resources in one area will mean ignoring the need in another. For example, often it is the case that municipalities are weighing the potential for more books in their libraries or more fire fighters. The resources operate on a zero-sum basis, but the needs and priorities do not. For the program manager, the objective of good financial management is, therefore, not just efficiency of delivering the program. It will also mean the effectiveness and impact.

13. For a good overview of New Public Management, see Salamon, The Tools of Government; Colin Talbot and Christopher Pollitt, editors, *Unbundled Government: A Critical Analysis of the Global Trend to Agencies, Quangos and Contractualisation* (London: Routledge, 2003).

- **Difficulty of Relating Costs and Benefits:** Governments are often challenged to determine the direct benefit of a specific action. Further, the line connecting resource expenditure and outcomes is often a very tenuous one. A series of causes and effects, some under the control of the organization but many not, can affect the final outcome. Further, outcomes can occur over an extended period of time and in an unpredictable fashion. Certainly, in the case of social and health services, the number of variables is immense. Human beings often exercise their free will, even with help to guide them to the desired improvement. This reality is hardly a reason not to pursue a better understanding of the outcome of public-sector programs. For the program manager, this is the challenge of attribution. If we do this with our resources to achieve this outcome, how do we know we have the costs right, that the investment will work and that the desired outcome will be achieved?
- **Performance Measurement Is Elusive:** Public-sector organizations often have a number of objectives that are difficult to measure. Measuring ultimate outcomes is one thing, but a very difficult one. Measuring interim outcomes or outputs is often a substitute, but at times equally difficult. For instance, is the objective of an educational institution to ensure employability of its graduates or to ensure a high-quality, engaged citizenry? The former might be measured more easily than the latter. In some instances, the focus of concern for members of the public is the inputs. For instance, citizens may ask if every part of the country got its fair share of the capital investment budget this year. This is a preoccupation with distributional and equity issues, a very important and legitimate concern in the public sector. For this reason, financial information and performance often inform performance data. Money spent, regardless of whether or not it is the best use of that money, can be traced and examined in a variety of ways where good public-sector financial reporting exists. Detailed program measures often cannot.
- **Apples and Oranges:** Often the distribution of resources takes place across programs that do not readily compare with each other. Similarly, some programs that may, at first glance, look alike are actually aimed at different goals. Comparing them would, therefore, distort the conclusions.
- **Service Orientation of Many Public-Sector Organizations:** The focus of many public-sector organizations is serving the client. They measure success in terms of how they are achieving that end, rather than how well they manage the funds. Often, this service orientation is dominated by a culture that can be hostile to effective financial management, seeing it as inhibiting effective client service through excessive controls, inadequate funding, or a preoccupation with paperwork over peoplework. The effective program manager does both.
- **Constraints on Goals and Objectives:** The reason that a public-sector organization exists is defined either by the laws and policies that government establishes, or by the objectives of the nonprofit voluntary agency. In neither case is the raison d'être defined by profitability. The consequence is that public-sector organizations do not change their mandates for financial reasons, but they do for policy ones. The interaction between policy and funds available is, of course, a different story. Here, policy intentions have to take into account funds available and costs. That is the heart of the budgeting process for any public-sector organization.
- **Varying Forms of Governance:** In government, it is a straightforward process to determine the legal authority that governs a public-sector organization. How decisions are made, however, is quite a different matter. Legislation creating public-sector organizations may be very broad with respect to the level of legislative control that is exerted as the organization goes about its day-to-day business. In fact, legislatures seldom engage in the actual management of public-sector organizations. Rather, they serve other key roles: creating the organization, setting out the policies that it will carry out, providing the funding to carry out the policies, and holding the organization to account for how it carried out the policies.
- **Political Realities and Necessities:** In government, all policy is created within a political context. Therefore, it is important to focus on some of the characteristics of politics that can affect financial management.

    - *Short-term orientation – from one election to the next: The need to get re-elected will often produce a short-term focus that drives out long-term considerations. Short-term results may be seen as more important than long-term effects This can have a serious impact on the budgetary cycles of governments. There is also a tendency to give less weight to such matters as maintenance of equipment than to direct services, even though these matters are essential to the long-term health of the organization.*

- *Need for visibility – show me the ribbon to cut: The desire to achieve high personal or governmental visibility will create an inclination to focus on new initiatives in government rather than on continuing operations. Since funds are limited, there will be a tendency to move funds towards the new and attractive and highly visible priorities.*
- *Multiple external pressures: The public sector, be it government or the voluntary sector, is all about multiple stakeholders. This can create pressures and counter-pressures within an organization to use funds in erratic or inconsistent ways to please various stakeholders.*
- *In a fish bowl: Financial management in the public sector is becoming an ever more transparent process. This is fed in part by the number of external stakeholders and their increasingly sophisticated understanding that the management of public funds drives some of the results that they want. It is also fuelled by the presence in most jurisdictions of some legislation relating to freedom of information. None of the key elements of financial management – budgeting, resource allocation, cash management, and accountability – takes place behind walls of privacy. Such transparency affects financial management in many ways, most of them positive. For instance, it forces those managing the processes to use clear language, to adhere to approved accounting standards, and to link financial information to the organization's goals. It also forces the financial professional community to better understand the impact of their work and the language they use in a broader context.*
- *Legislative restrictions: Public-sector organizations are governed by many different pieces of legislation, all of which impose requirements for the organization to behave in certain specified ways. Mention has already been made of freedom-of-information legislation; in addition, in most complex governments, legislation will set out various financial rules. Some legislation is difficult to change, thereby entrenching certain practices that could benefit from change.*

- **Managerial Constraints:** Public-sector management has many unique characteristics that will affect the way in which financial management can be practiced. These characteristics go well beyond the considerations of operating in a political context:
  - *Management cultures: Leaders of public-sector organizations often do not see themselves as managers of resources, but rather as policy managers, operational managers, client-focused managers of highly specialized functions such as scientific research. Because of the complexity of these organizations, the finance function will have its own senior managers, who are often separate from these line or operating managers. Tensions often develop between these two cultures. The abilities to obtain resources to achieve program objectives (budgeting), maximize program benefits within the budget (allocation), effectively manage the budget to achieve full benefit (control and risk management), and demonstrate results and adherence to process (accountability) are important management skills. In many cases, they are incorrectly identified as finance functions. Financial experts in government plays a supportive role but can often acquire an inappropriate dominance in the absence of effective core management and an effective union of the program/policy culture with the financial management culture.*
  - *Bureaucratic rules and regulations: Financial rules often are seen as bureaucratic impediments to getting things done. The complexity of government, the dual focus on process and product, the high level of transparency, and the multiplicity of stakeholders guarantee that the public sector will have rules and a dominance of regulation to guide decision making.*

Summing Up

Financial management is a key element in delivering public goods. To effectively understand financial management requires an understanding of the role of policy within the public sector. Resources are not managed in a vacuum, and the ways in which funds are managed are matters of public administrative policy. This applies to the means of management, to the distribution of the public good or service, to the way in which it is distributed, and to the mechanisms of the accounting for the way in which the public funds are managed. A great deal of public policy is as much about means as it is about ends.

Financial management is an integral part of public management. A public servant cannot be effective in his or her role without a robust understanding of the key elements of

financial management. That does not mean that all public servants need to be accountants or experts in finance. Nevertheless, they must be concerned with public resources from the start of their work in the public sector, be it in a policy role or in a front-line service role. As they become managers, their responsibilities as financial managers grow. They are, in fact, financial managers. It is for this reason that the need for an effective measure of financial literacy is an important personal – and organizational – asset. That is not a specialized role. It is, in fact, a general one shared by all managers. Indeed, financial experts are an essential part of any functioning public-sector organization. They, too, play a variety of roles, some of them in apparent tension with line managers, some in complement. In order to have accountability, though, it is the line manager who must be seen as managing the finances of the organization. The financial specialist is needed to advise and guide in a variety of ways. Further, the financial specialist makes sure that the underlying financial and accounting systems of the organization function in the intended manner. The financial specialist also serves at times as controller, ensuring compliance with reporting standards and challenging cost and program assumptions. The financial specialist brings to the organization a unique set of skills without which it cannot function. Unless those skills are integrated with those of the program or policy manager – the reasons for the organization's existence – they are of not much use.

The focus of this text is the financial manager, not the financial specialist. Built into that focus is the expectation that public-sector managers will develop an understanding of how finance works, how their legal framework guides their financial responsibilities, how to rely on and use financial experts in all phases of financial management. Hence, the need to pursue financial literacy. Financial experts, on the other hand, need to develop an understanding of the policies and directions of the organizations in which they work. They also must develop ways to translate legal financial requirements into sound managerial practice. Because of the complexity of public-sector environments, the one does not trump the other.

Another important implication for financial management in the public sector is the need in large organizations for countervailing checks and balances. Governments manage significant risks on a daily basis. To do that, they need to have information and advice from different perspectives, one being the program manager, the other being the financial advisor. There are varying levels of oversight and authority in large bureaucracies. Performance is monitored both internally and externally. Taking a corporate view of the financial situation will be different from taking the program view. Above all, sound organizational management means that the senior managers have good financial information to determine if their managers are performing well and objectives are being achieved. To that end, they set up oversight functions such as a finance unit that monitors and advises on budget performance of managers to get an early indication of risk or identify the possibility of funds becoming available for other uses. And, the basic rule of public-sector programs: there are always other valuable and needed uses for funds.

Chapter 2
Framework Concepts: Accountability & Risk

Why Here and Why Now?

Accountability and risk are pervasive elements throughout the public sector. We will see in this text that the basic flow of financial management – getting resources, spending them and reporting on results – demands various forms of accountability along the way. Woven into this is the role that risk plays in establishing accountabilities, identifying and mitigating variances or events that cause some adjustment in spending plans, and the degree of reporting that risk informs is needed. Therefore, these two concepts are being explored early in the development of the financial management framework. They will be relevant throughout the text. Just as the public sector framework discussed in Chapter 1 and the accounting framework laid out in Chapter 3, form the core of public-sector financial management, accountability and risk inform the setting of budget levels, their distribution, the degree of oversight and reporting needed in implementation, responses to changing circumstances that might affect the desired outcomes, and internal and external reporting of performance. That is pretty much the full cycle of financial management.

Another reason for taking a look at these concepts at this point is how much each of them is misunderstood. Simply put, too many times accountability is equated with blame and risk is seen as inherently bad, to be avoided, ignored or supressed. From a healthy public management perspective, both these concepts of accountability and risk are vital and positive concepts. The program manager is wise to take them on board. Accountability is a way of securing the resources, authority and direction to act. It is a way to set the expectations for the manager and, through reporting back, to confirm that the desired outcomes have been achieved. Accountability is a two-way street, but only works when there is clarity of objectives and certainty about resources, something we see too often not working well in government. Risk, on the other hand, is all about that pesky real world impinging of the best laid plans, forcing adjustments to approved plans and budgets or making course corrections when expectations are not met. A healthy appetite for understanding risk does not equate to wanting to take a lot of risks in a reckless way. In budgeting, it is about trying to define uncertainties with respect to the budget decisions and deal with them such as providing contingencies in budgets for potential cost changes. In managing a budget in-year, risk is about elements that we will explore in Chapter 9 that have changed that force you to make adjustments in your plans to either mitigate the negative effects of, say, a cost increase or present an opportunity to improve delivery and adapt to changing circumstances. Being risk smart, therefore, is about a ready desire to understand and manage the risks. It is certainly also, at times, about making decisions that are inherently risky because of the lack of full information or costing, but are made because of the urgency to act. This can end well or end badly, which drives home the message that taking risks requires that the manager has his eyes wide open and can assess the risks without biases clouding the information that they actually have.

We have accountability to show that we have indeed carried out a public policy goal and done so in the manner required. We use risk tools to ensure that we stay on track to enable that accountability. Let's then take this idea and apply it to the dynamics of government organizations. Inherent in the accountability model that will be presented here is the notion that different levels of the organization will take on responsibility to manage resources and to achieve results within a set of delegations, rules and objectives. This is never a perfect process. As well, these delegations are distributed widely in large public organizations. As managers implement, they adapt to changing circumstances. They identify risks to seeing their goals achieved and adapt through changes, innovation or various forms of risk flight. But adapt they do. In doing so,

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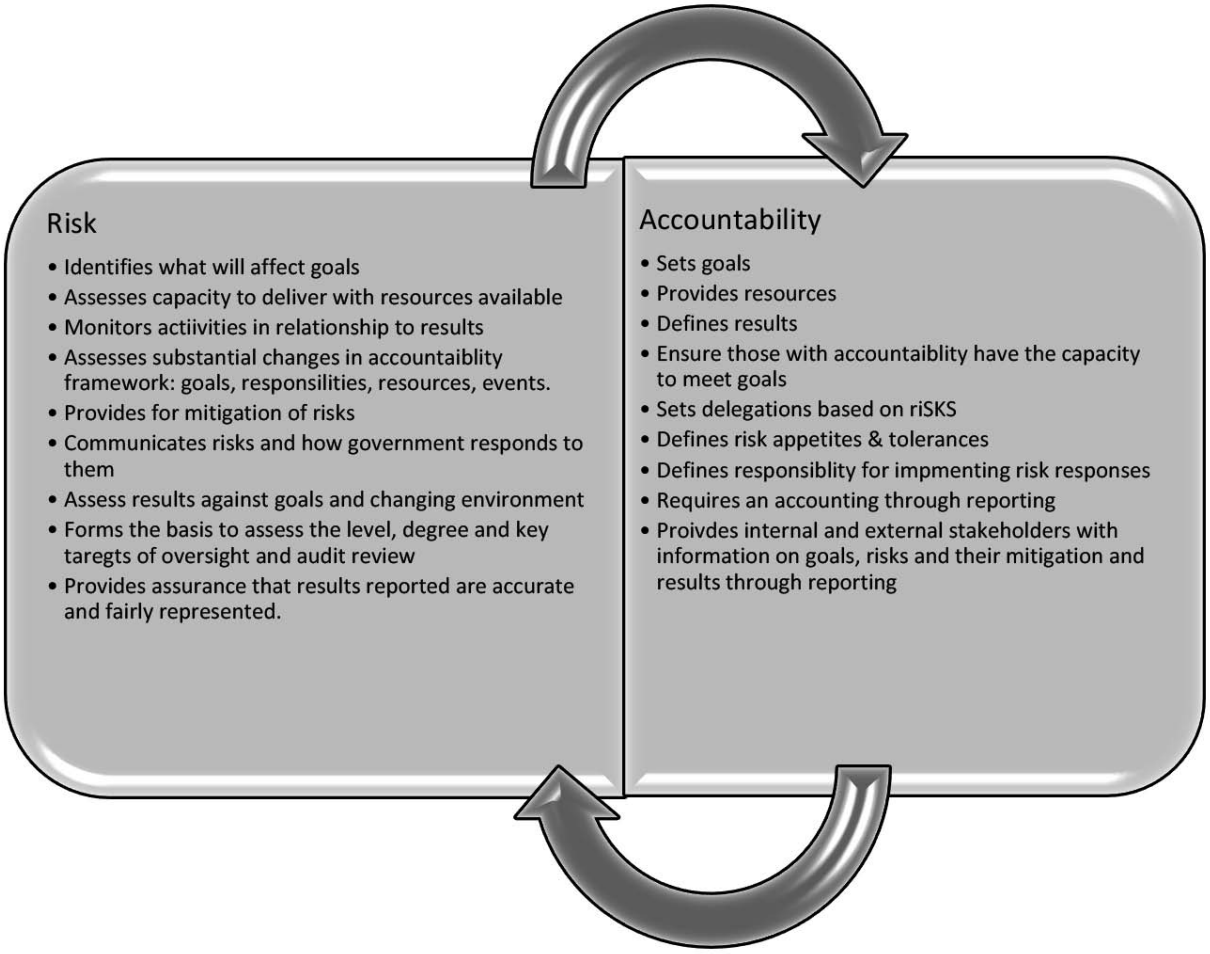
they take risks. This is risk mitigation, making decisions to stop or start an activity, to report the problem, to reallocate resources to fill the expenditure gap. All these involve risk calculations. Managers may also take risks that, for instance, they will be on budget even though early indications are that there is a problem. Hopefully, this is not an act of blind faith, but rather an informed calculation of the outcomes based on contextual knowledge, past history, and a preparedness to change to take into account the need for greater control. Figure 2.1 shows some elements of how risk and accountability affect each other and why they are core concepts.

Bringing risk and accountability into harmony is a principal objective of financial management practice. In fact, both organizations and individual actors within the

Figure 2.1
Risk and Accountability Interact


Risk
• Identifies what will affect goals
• Assesses capacity to deliver with resources available
• Monitors actiivities in relationship to results
• Assesses substantial changes in accountaiblity framework: goals, responsilities, resources, events.
• Provides for mitigation of risks
• Communicates risks and how government responds to them
• Assess results against goals and changing environment
• Forms the basis to assess the level, degree and key taregts of oversight and audit review
• Provides assurance that results reported are accurate and fairly represented.
Accountability
• Sets goals
• Provides resources
• Defines results
• Ensure those with accountaiblity have the capacity to meet goals
• Sets delegations based on riSKS
• Defines risk appetites & tolerances
• Defines responsiblity for impmenting risk responses
• Requires an accounting through reporting
• Proivdes internal and external stakeholders with information on goals, risks and their mitigation and results through reporting

system are constantly adjusting the balance through such actions as:

- Sound budgeting that clearly fixes resources levels based on good costing, reliable information and a robust understanding of the risks inherent in implementation.
- Good costing that takes in account a variety of risk factors, enabling adaptation as more information becomes available as the program is rolled out or circumstances change.
- Accounting practices that a manager can count on to provide timely and relevant information on financial performance.
- Effective identification and mitigation of risk throughout the financial management cycle.
- Good financial reporting and governance, what we have already identified as the financially literate manager working in a financially literate organization.
- Sound control and budget management with good information received in a timely manner that enables managers to respond to new challenges, changing circumstances.
- Useful and usable performance information that is linked to financial information.

Accountability: Big Idea with a Broad Reach

Accountability is a tough concept. It is often associated with blame and punishment. Scandals abound. So to do headlines about them. Here we will take a deeper look, but with a focus on the role that financial information and reporting play in supporting accountability in delivering public goods. Accountability is a concept with a broad and positive reach for public sector organizations. It encompasses operational processes, management control, the effectiveness of those controls, the efficiency with which the organization carries out its work and its adherence to the laws and requirements for probity and, of course, what results it has achieved. These elements form the basis of accountability as applied to the internal management of organizations. Here the accountability is to render an account of one's duties and report on the execution of the responsibilities that you have received from them. In this context, it also means to be subject to scrutiny, questioning, and formal review. Accountability also extends to relationships with service providers both within the public sector and into the private sector through contracted services, contribution agreements, and funding supports. These relationships include some form of reporting or accounting for the proper use of resources and delivery of results.

To demonstrate control and adherence to due process, as well as ensuring the efficient and effective realization of the organization's objectives, is often challenging. Accountability can also be costly, adding to the overall cost of administration and, in some instances, straining the skills and abilities of the personnel within the organization to provide the kinds of accountability demanded of them. However, cost or inconvenience provides no excuse to avoid accountabilities in public organizations. There have been a number of developments in the past decade to increase overall government transparency in financial reporting. As well, technology has driven an increased capacity to derive more analytical, forward-looking information from financial and operational reporting. This development, only now emerging as a powerful public sector tool, will certainly change the nature of performance reporting, as the early evidence has already shown. It also serves to expand the reach of external accountabilities to know and understand what is happening in government.

This chapter will focus on the mechanisms for accountability in public organizations. However, throughout, the principal objective is to focus on how public organizations can build, nurture and sustain sufficient trust to be able to operate with adequate managerial flexibility while maintaining credible accountability. The same concern applies to organizations that provide governmental services through third-party arrangements, as they must account to the government contracting with them. These can be complex contractual relationships, none of which diminish the public organization's ultimate responsibility to account to its legislature or board. The need, therefore, to ensure that there is an unbroken thread of accountability within these relationships is a preoccupation of governments as they broaden their use of third-party delivery options.

The Public Sector Accountability Landscape: Accountable for What?

Modern concepts of accountability for public finances are widening and deepening. In Chapter 1, we looked at a number of features, mentioned in the **CPA Public Sector Accounting Handbook**, that distinguished government from business. Most pertinent to this chapter is that "Governments are held to a higher standard of accountability than a business or a not-for-profit organization."[1] To develop some further precision around that concept, the

1. CPA, Public Sector Handbook.

Public Service Accounting Standards Board, in its 2012 Consultation Draft Paper, **Measuring Financial Performance in Public Sector Financial Statements,** suggested that there are three broad accountabilities expected regarding the financial affairs of a public sector entity:

1. **Performance:** The extent to which the entity performed in accordance with its financial plan by providing information on actual versus budgeted results. Further, the extent to which those financial results are linked to program goals and results.
2. **Forward Impacts:** The extent to which current activities and results have an effect on future activities and results, including inter-period equity, sustainability of policies and programs, annual accumulated surplus or deficit, and risks inherent or created by present behaviour.
3. **Financial Condition:** Based on accurate financial reports, reporting on key aspects of financial condition, including net assets, cash and cash flows, debt and other liabilities, capital assets etc. Further, reporting on the sustainability of the entity, the risks associated with its financial position and the annual and accumulated surplus or deficit.[2]

Suffice it to say that all public organizations face accountability challenges. These challenges are both internal and external, as we will see below. Further, public organizations tend to be confronted with an array of accountabilities that, in the strictest sense of this concept, are not really formal accountabilities, but rather a series of requirements to deal with stakeholder concerns, media demands and other issues. In any event, accountabilities in the public sector have the following characteristics:

- **Transparency:** Virtually all of the accountability systems within government are subject to various forms of scrutiny or access rules that ensure that all information on performance, financial probity, results and evaluative information becomes public. In fact, as we will see in **Section 4, Reporting and Measuring Performance,** the question of external reporting to legislative authorities and various stakeholders is a matter of government policy and an inherent characteristic of the public sector.
- **Multiplicity of External and Internal Accountabilities:** Very few public organizations have what might be called a straight-line accountability to a single owner, board, or set of shareholders. Rather, they have formal and informal accountabilities to legislatures or councils, but also to users of the services, clients, the public in general and others. There is also a multiplicity of forms of accountability. While the focus of this text is financial management, it has recognized throughout that public organizations work to achieve a number of concurrent ends: good policy, adherence to the law, and financial probity and proficiency. Attempting to report on, and be accountable for, all these ends is a challenge. Certainly, financial statements cannot by themselves provide enough information to measure all these different areas of accountability.
- **Hierarchical and Horizontal Nature of Accountabilities:** There are accountabilities strictly within an organization. These are hierarchical in nature. Similarly, there are reporting and accountability requirements to legislatures or councils. These, too, are hierarchical. However, at the same time, there are accountabilities that involve collaborative work among organizations that are working towards a common goal. Similarly, as governments move increasingly to using shared service organizations within the government to provide administrative services to all departments from one source, they also begin to experience the challenge of internal service accountabilities.
- **Qualitative and Quantitative:** The goal of sound financial management is to produce high quality reliable, verifiable and trustworthy financial information that is linked to the performance goals of the organization. Is that enough? Not in the public sector. All the best financial data in the world about a bad policy and a set of numbers that show how well it has been administered does not make it a good policy. That is why quantitative information must be supplemented with qualitative information to get a full understanding of the impact of a particular policy. Further, many accountabilities are also soft or fuzzy, both code words for qualitative rather than quantitative. For example, it has been well established that staff morale is an important factor in the success or failure of an organization. While this can be quantified to a certain extent, it is more qualitative in nature as it looks at elements or organizational culture, which is hard to put into exact numbers. Applying a risk lens, however, the cost of replacing staff who are leaving because of morale problems can be readily identified.
- **Focus on Both Results and Compliance:** In the public sector, the *how* in achieving organizational goals is often as important as the *what*. The how is focused on compliance with rules, probity, equity,

2. See www.frascanada.ca/standards-for-public-sector-entities/.../item68525.pdf

fairness and adherence to procedures. The what is about the achievement of a public good. The tensions here are evident. Achieving results often means being adaptable and flexible. Complying with rules generally means the opposite.

- **Complexity:** It is clear from the above that there is a complex accountability landscape in the public sector. This applies to both the operations of the organizations themselves – the internal accountabilities – and the external accountabilities to legislatures, boards of directors, memberships and the general public.

What public sector managers are accountable for starts with some top-tier elements:

- Effectiveness of the program
- Efficiency of delivery
- Sustainability of future delivery, and
- Probity in delivery and reporting.

What financial reporting has to contribute also has several elements:

- Accurate formal financial statements to match actual to budget
- Timely information within the budget year to enable a firm understanding of the financial position of the unit or agency, and adjust through cash management
- Linking the cost to the program outcomes, and
- Accuracy and transparency in reporting to ensure confidence in the numbers being reported.

What Accountability Means

Many words are used that can confuse an understanding of accountability in the public sector. The late Arthur Kroeger, a former federal deputy minister, made a presentation to the Public Accounts Committee of the House of Commons in which he drew a distinction among accountability, responsibility and answerability. It was an important contribution to understanding accountability, since there is the danger of its being over-used and slipping down the rabbit hole of blame only. In the public sector, maintaining an understanding of whom one is accountable to is important in maintaining democratic institutions. Mr. Kroeger describes three obligations of ministers, but notes that they extend to any public official:

- **Responsibility:** "To be the Minister responsible for a department of government means that you are in charge of it. … If you are the Minister in charge of a department, then you have an obligation to oversee and direct what it does … What responsibility does not mean is that you are required to know and control everything that is happening at all times."
- **Accountability:** "An accountability relationship beings with a conferral of authority by one party on another. When authority is conferred on you, you also acquire an obligation to account for how you used that authority. In a strict sense your accountability is only to the person or institution that conferred the authority on you."
- **Answerability:** "People in positions of authority may be called to explain themselves and justify their conduct to many different parties [to whom they are not accountable] … This type of obligation for people in authority can best be described as 'answerability'."[3]

Our focus here is on accountability. Professor Janice Stein of the University of Toronto, in her book, ***The Cult of Efficiency*** defines accountability in the following way:

> Accountability is about evaluating performance, meeting legitimate standards, fulfilling legitimate commitments, and holding responsible those who fail to meet the standards. The right to judge government performance flows naturally from the role of citizen, as does the right to sanction those who fail to meet the standards.[4]

Christine Ryan and Peter Walsh of Queensland University of Technology, in their review of shared accountabilities, note that:

> An inherent feature of accountability in the governmental context is that some identifiable individuals or defined groups are held responsible for a set of activities that correspond to their actual span of control and capacity to act.[5]

What, then, are the principal characteristics of accountability relationships in the public sector, regardless of their complexity?

- **Assignment of Authority, Power and Resources:** This is the delegation of duties to an individual or organization. This can be by law, by policy, by way of formal delegation matrices, or by the completion

3. Statement by Arthur Kroeger to the Public Accounts Committee of the House of Commons, 21 February 2005 – with permission of the author.
4. Janice Gross Stein, *The Cult of Efficiency* (Toronto: House of Anansi Press, 2001).
5. Christine Ryan and Peter Walsh, "Collaboration of Public Sector Agencies: Reporting and Accountability Challenges," *International Journal of Public Sector Management* 17, no. 7 (2004): 612–631.

of an organizational work plan, budget distribution, and performance contracts. It can also be implicit or indirect, such as using formal position descriptions to describe duties that have delegations of authority in them and a statement of expected duties to perform and, possibly, outcome expectations.

- **Accountability for Performance and Results:** In accepting the authority, power and resources, the individual or organization also takes on the responsibility to perform the work and account for the results.
- **Assignment of Duties:** In assigning duties formally, the granting authority also provides clear direction, legislative or regulatory guidance, and resources consistent with the expectation.
- **Requirement to Report:** The necessity to report in a formal way, often prescribed by the granting authority, deals with three elements:
  - *results achieved,*
  - *compliance to legal and procedural requirements, and*
  - *efficiency.*
- **Judgement Exercised:** At some level, be it within the organization and with the public at large, public sector accountability involves the right of the granting authority to make judgements about how the accountability has been exercised and act on that judgement. In the ultimate test, in a democracy such as ours, that may mean the downfall or re-election of a government. In more mundane terms, it may be a clean bill of health on a financial statement by a legislative auditor.

These characteristics are illustrated graphically in **Figure 2.2, The Accountability Dynamic.**

Figure 2.2
The Accountability Dynamic

Authority, power, resources, goals
Individuals or organizations accepting accountability
Individuals or organizations conferring accountability
Accountability for performance, results, and efficiency
Financial and performance reporting

Unless the two sides of this dynamic are in place, an individual or organization cannot be held accountable. To be accountable, they must be given the direction, authority, power, and resources to do something. However, in this dynamic, there is a reciprocal duty to account for, explain, and report to those conferring those powers. One cannot happen without the other. A word of warning: having the two elements, essentially a principal and agent, in place is essential. However, in an ideal world they are also in balance. The goals are understood, resources are sufficient and in place, delegations are clear, results are defined. In reality, this is not always the case. There can be a mismatch of any of the elements. In addition, circumstances change, events happen and things just do not work as planned. Therefore, the accountability continuum needs a way to adapt and adjust. Risk tools – a few examples are regular reporting against plan, variance analysis, risk reporting – are key to ensuring this dynamic is present.

The Range of Accountabilities

Accountability takes place at different levels and for different results. **Figure 2.3** presents a grid of accountabilities that we would typically find in an agency of government. These accountabilities start with internal processes and inputs, that is, those resources such as people, material, and equipment needed to deliver a program through to the actual results of the program in terms of its outputs. The outputs are what it produces in terms of services and the eventual outcomes, in other words, the impact on the client or policy objectives. In between are those accountabilities associated with doing the right thing right, process compliance, legality, economy and efficiency.

Public sector organizations are accountable for the full range. For instance, within an operating unit, there are operational accountabilities. These would involve the day-to-day operations of the unit, ensuring that both operational requirements are met and that all safety, production targets are met. Then there are managerial accountabilities, often closely linked to the operations. For instance, is the unit experiencing program pressures that will affect its overtime budget? Is staff hired to fill all positions? Is the unit operating within its budget? As can be seen in the figure, information supporting these questions is closely related to what we call managerial coefficients, the measuring of activities, inputs and relationship to budget expectations. Financial accountabilities are an inherent part of any set. They will include compliance with financial procedures, the establishment and effective use of controls, staying within budget and providing the required reports to support all of that. Moving along the range, the accountability array begins to take on both an internal and external orientation. In the area of compliance, an important element in many public sector organizations, internal and external standards or prescribed processes, often mandated in law or regulation, will have to be measured and assurance of compliance given.

The last two columns in this grid deal with more external preoccupations. Outputs are the products, services or facilities that result from an organization's activities. Accountability here is to deliver the public good as promised in the budgeting and planning processes. Outputs relate directly to the objectives of the agency. For example, a social agency may plan to provide literacy training for up to 1,500 clients over a fiscal year. The output goal becomes 1,500 clients receiving that service. The performance indicator developed from that could be the ratio of the number who received the services over 1,500. In financial performance terms, it could be that the percentage of the assigned budget was spent for the intended services, or the average cost of the individual service in relation to a benchmark service cost that compares with agencies in other jurisdictions.

Outcomes relate to the policy goal of the activity. Outcomes are the impact of the agency's outputs on a broader policy goal that may involve many contributors other than this one agency. Here the preoccupation is with the program goals of the organization and how they contribute to a policy outcome. It is often the case that no one public sector organization is solely responsible for a complex public good. For instance, using the literacy training example from above, the policy outcome could be that individuals with improved literacy are able to read better and are, therefore, more ready for the job market. The short-term outcome is literacy capability, which may relate directly to the training fairly well. The medium and long-term goal of employment may be a much more complex set of issues. Literacy may be one impediment to employment. There may be many others. Therefore, while the output of the agency in literacy training may contribute to the ultimate outcome, it is not the sole contribution attributable to accountability in this complex equation.

This is known as the attribution problem in public-sector accountability.

Governments and agencies therefore try to make sure that there is an understanding of the degree to which what they do contributes to outcomes. They do this through building a policy model that links its chosen outputs to a desired outcome, to limit the degree of attribution to what that agency actually feels it can do to affect the desired outcome, and to continuously re-evaluate the underlying assumptions of that model.

Figure 2.3
The Range of Public-Sector Accountabilities

Range of Accountabilities					
Internal →					**External**
Operations	Management	Financial	Compliance	Outputs	Outcomes
Measures focus on managerial and financial concerns	→				Measures focus on program information and finances
	Financial Information Needed in Each Accountability Set				
• Costing • Spending within authorities • Procurement compliance	• Budget in place • Authorities and delegations in place • Performance against budget	• Financial reports – internal • Variance analysis and reports	• Procedures followed • Risk profiled and controls in place • Delegations in place	• Budget set against target • Audit clearance on program • Financial statements • Indicators of performance	• Program expenditure profile • Value for money

All these forms of accountability are present within an agency at one time. The degree of focus and use of the information needed to support them will vary with the focus of the individuals within the organization. For instance, a unit manager in a mental health facility may have a strong operations focus but with budget and compliance responsibilities as well. Her preoccupation will be on the left side of the chart – operations and management. A corporate planner in the same facility may, however, be focused on overall results and future planning. Her orientation will be on the results achieved by the hospital and, to a certain degree, the impact these results have on broader desired outcomes.

Public agencies need information about all forms of accountabilities. Some characteristics of the accountability dynamic and the interplay with financial information as a key indicator of accountability should, however, be kept in mind. Reporting is not a free good. It takes resources. Therefore, the exercise of accountability needs to find the most reasonable and least expensive means to provide information. This is a very real challenge as some accountabilities are external, either to a governing entity such as a board, to a central departmental office or to a central agency. Such reporting can be burdensome. Second, accountability is not just about reporting. It is also about assessing what is being reported, against the desired outcomes in the accountability bargain struck between the principal and agent and deciding, quite simply, how things are going. This is where risk management comes in.

Accountability and risk are linked concepts in financial management. Accountability is about holding multiple players to account for results they committed to achieve through a system of performance measurement, rewards, incentives, punishment. There is a constant push and pull between those objectives that everyone is committed to and the challenges of meeting them. Risk management is about reducing risk exposures to achieving objectives in a way consistent with who is accountable for what and can afford what. Risk management requires a constant calibration and recalibration of the tools of implementation to achieve objectives. Therefore, accountability is a dynamic push and pull between expectations and their execution. It is not static but very much a dynamic one. Risk inherent in the accountability relationship is also dynamic since you are constantly assessing the impact of events and change on your objectives. One drives the other: most accountabilities are meant to address risks, to avoid error, to ensure compliance, to achieve something.

Risk and Risk Management

Risks are inherent in all aspects of public sector policy delivery. It is, as has been pointed out above, something that government takes on when no one else will. It is therefore a defining characteristic of the public sector. However, it is very important that an analysis of how risk and risk management fit into financial stewardship that we avoid the emotive notions of risk as risky and, rather, see risk as inevitable, to be managed and either mitigated or taken advantage of. Knowing the risks, the degree that they impinge on results and then putting in place accountability regimes is the way to balance off excessive internal and external control systems and a fear of delegation and trust, blame-driven accountability and provide internal clarity on objectives and priorities. In financial management, only effective risk management will constrain notions of total and costly control (what you can do and from whom you have to ask permission to do it) and only accountability will create the basis for both action (doing with the funds) and reporting (what you did with the funds).

In 2011, the Auditor General of Canada, the office responsible for the oversight of the federal government's spending for Parliament, provided a useful overview of the importance of risk management, with a sound linkage to accountability:

> Canadians expect the government to be well managed and to handle taxpayers' money prudently and economically. To do this, the government must exercise sound financial management and control and risk management within the requirements of the *Financial Administration Act* and regulations. It must also follow relevant Treasury Board policies, directives, and standards, and be guided by principles of value for money, accountability, transparency, and risk management. This means that systems, practices, and resources need to be in place to ensure that
>
> - Public funds are managed prudently and honestly.
> - Assets are safeguarded.
> - Resources are used effectively, efficiently, and economically to achieve government objectives.
> - Accountabilities for financial management are clearly established.
> - Financial risks are being mitigated by effective internal controls.
> - The Canadian public and parliamentarians are provided with pertinent and reliable information on the use of public funds.
>
> Significant deficiencies in these areas of financial management and control and in risk management can have detrimental effects on the level of service that Canadians receive and the government's credibility.
>
> To be well managed, an organization must identify, assess, and respond to risks that could affect the fulfillment of its objectives. Integrated risk management involves managing risk across an organization in a coordinated and systematic manner. This assists an organization in better understanding the risks it faces – for example, financial, environmental, strategic, and operational risks. It also assists an organization in making informed decisions about how to mitigate threats that could have an impact on its ability to meet its objectives, and how to take advantage of the opportunities that uncertainty presents."[6]

These comments confirm that risk is part of any business and those that fail to manage it are, in fact, creating more risk for the organization, be it private or public. There is no doubt that risk is a tough concept in a politically sensitive environment like the public service. Government is often described as being risk averse. Being risk averse implies not managing risks. That is not being risk averse; that is being risk stupid. An effective system of control is built on the presumption that some level of risk exists within the organization. Identifying and assessing risk but failing to act on it is irresponsible and not particularly helpful. Governments work with risk every day. Governments are on the constant watch for risks that have to be mitigated or that signal a need to adapt policy to changing circumstances. Even in financial management, where risk assessment and mitigation are elements of well-known sound managerial practice, an underlying concern always exists that a robust preoccupation with risks is politically unacceptable or an admission that all is not well. This is unfortunate, since the steadiness of the political state of affairs depends greatly on the support of a bureaucracy that has a capacity to mitigate many of the programmatic and political risks that often land politicians in the answerability, if not the accountability, zone to which they have some legitimate aversion. The simple reality is that it delivers its programs with considerable uncertainty about certain outcomes, about factors that can affect their successful realization

6. Auditor General of Canada, 2011 Annual Report. See http://www.oag-bvg.gc.ca/internet/English/parl_oag_201106_01_e_35369.html

and about assumptions of cost, probity and predictability. Rather, risk management that serves the agency and its leadership will involve the identification, assessment, mitigation, communication, and reassessment of risk on a continuing basis. For the purposes of internal control, this is essential. You cannot run from risk. You have to engage with it. A recent paper by COSO, an international body providing thought leadership on risk in business argues for the centrality of risk in executing a strategy or, as in our context here, in delivering on accountability, that is the near antithesis of the risk averse mantra: "Once strategy is set, enterprise risk management provides an effective way for management to fulfill its role, knowing that the organization is attuned to risks that can impact strategy and is managing them well. Applying enterprise risk management helps to create trust and instill confidence in stakeholders in the current environment, which demands greater scrutiny than ever before about how risk is actively addressing and managing these risks."[7]

Defining Risk and Risk Management

Risk is not just about bad things happening. Nor is it about organizations being surprised or thrown off by events or unexpected events. These things happen and have to be factored into how the organization manages its resources. But the reality is such events and surprises are inevitable and how organizations respond to them will depend on how they affect their objectives. In addition, organizations are constantly measuring their performance, scanning their environment and engaging in consultations with stakeholders. They pick up ideas, trends and anomalies that might tell them they will have an impact down the road on the how they are going to meet their objectives, execute their strategy or have to adjust their accountabilities. In understanding what risk is, we have to see this constant flow of information and its assessments against plans as being at its heart.

The International Organization for Standardization (ISO), in its ***Risk management – Principles and guidelines on Implementation***, defined risk as "the effect of uncertainty on objectives" (CSA/ISO 31000). This was a major step away from looking at risks as hazards or dangers. The new definition is neither positive nor negative, which reflects the fact that many risks represent opportunities to make adjusts, correct well in advance of a possible negative outcome or leverage the risk to improve the program or reduce costs. Further, risk is not some random idea of bad things happening. The organization's goals and plans have to be clearly articulated and accepted before it can identify risks. It has to be able to predict, with varying degrees of certainty, some future events and their meaning relative to objectives. It must also be able to gather and distill information outside its current framework that will affect that framework, its goals and mission.

Case Study: Risk Assessment

To identify and asses a risk, a unit operating a loan program will be very concerned about the risks of default and what steps have to be put in place either to avoid this risk (applicant clearance procedures designed for high-risk groups) or to recover money when the loan is defaulted (special programs for repayment negotiation). But, in order to do that, the unit has to have some understanding of the risk in terms of the likelihood of it happening and the impact of a default on the program.

Accordingly, the manager of that unit would regard the default situation as a risk that must be managed actively in order to achieve the program's objectives. The manager will have to answer two questions just to get a risk assessment:

- Vulnerability: How susceptible are we to the risk of default?
- Exposure: How much are we at risk? What do we have to lose?

The manager can assess vulnerability through several means. She can look at the program's history. What has happened in the past? She can look at current trends. What is happening now and is it any different? She can then assess this in terms of the program's default expectations, a kind of risk tolerance. What would be a normal default rate? Remember normal does not mean acceptable. She may also have some sense of the efficiency of the loan repayment program in terms of the rate of bad debts over time. Bad debts are ones that are not recoverable after reasonable efforts have been made to do so.

Looking at the exposure, the manager will want to know if the risk is material. By this we mean, is the risk of a level that is significant for the program. Are the rates and size of defaults rising? Are defaults more likely to occur than in the past? Are there special circumstances that are pertinent here, such as defaults rising in one part of the country? How much money is involved? These questions address the question of the impact of the risk.

7. COSO, Committee of Sponsoring Organizations of the Treadwill Commission, "Enterprise Risk Management Integrating with Strategy and Performance" 2017.

Doing something about this risk depends on the answers to the questions in this small case. The manager may conclude that, while the risk exists, the pattern is normal and the recovery procedures should work to reduce bad debts to a normal range. Alternatively, the manager may conclude that the current processes, which are part of how the manager exercises control in the program, are insufficient because circumstances have changed and the risk is now higher and need to be addressed. She may take special measures, introduce new recovery staff, report the anomaly to her supervisor, assess if the environment has shifted in an important way. She has taken the first steps toward managing the risk.

Risks Take Different Forms

For financial management, some of the forms of risk are:

- Shifts in policy direction or adjustments as policy is implemented that change costs or require more funding
- Changes in the costing of program inputs due to changes in the cost of raw materials or other market conditions
- Managing funds ineffectively that produces cost over-runs or failure to operate within budget
- Inadequate or unrealistic funding combined with exaggerated objectives
- Fraud or misuse of funds
- Unforeseen circumstances that strain or threaten the financial capacity of the organization
- Losing the confidence of the public, the legislature, donors, or stakeholders in the organization's capacity to deliver its services as promised
- Administrative mishandling of funds: overpayment or erroneous payment, loss of revenue, theft of property
- Poor control and oversight of operational and financial performance
- Lack of timely and useful information about performance, emerging variances and changes to the environment.

But there are other risks in public sector management that have a direct bearing on financial management. It is for the reason that risk management is not simply a financial responsibility. Some of those risks are:

- Policy Risks – Is the policy design adequate and has implementation been adequately planned and costed?
- Public Interest Risks – Are the actions being taken, through policy, financial decisions or program design, causing harm to the public, or a significant element of it?
- Management or Organizational Risks – Are the ways we manage our resources creating risks to their distribution and effective use?
- Project Risk – Is the project, which is a time limited effort for a specific purpose well designed, funded and controlled so that it can deliver the results in a timely manner?
- External Capacities Risk – Are those upon whom the organization depends (both within government and outside) capable of delivering what is needed?
- Operations Risk – Do you have the human, technical and knowledge resources to deliver on objectives?
- Information Asymmetry Risks – Is information about risk being shared and understood by all who need to be involved?
- Disaster Risk – What is the likelihood of a major disruption in service?

The assessment of individual risk is built on the notion of uncertainty. Therefore, while risks may abound in the imagination, they take some work to actually anticipate, and then decide how to deal with them. We can also see how one can become consumed by risks or the fear of uncertainty. As Sir Humphrey (of the 1970s British comedy, *Yes Minister*) would say, "I can foresee all kinds of unforeseen difficulties here, minister." When the minister asked for specifics, the bureaucrat replied: "How should I know? They are unforeseen!" Of course, that is hardly effective risk management, and it is an approach that is not recommended in this text, but it was certainly effective ministerial management if Sir Humphrey's objective were to discourage his minister's desire to do something. The reality is that most political leaders fully expect their public servants to manage most of the risks in their agencies and only involve them when needed.

Most modern public sector organizations engage in risk assessment. Certainly, any effective individual manager will be constantly assessing risks. However, assessing risk and doing so on an individual basis is insufficient and dangerous. To simply identify risks is but the first step in a much broader process called risk management. To only identify risks and not act on that assessment actually creates a further risk: failure to act on what you knew. If a public organization is aware of a risk situation and fails to act, it is open to the legitimate criticism based on key questions: "What did you know about this? When did you know about this? What did you do about this?" The risks are in every environment. The capacity to identify them is a key management function. The need to move beyond

assessment towards mitigation is yet another key management function. Not all risks are equal. Not all risks require action. Prioritization and assignment of those priorities is what risk management is about.

Risk Management

Risk management is the process that supports the effective treatment of risk. It can be defined in the following way:

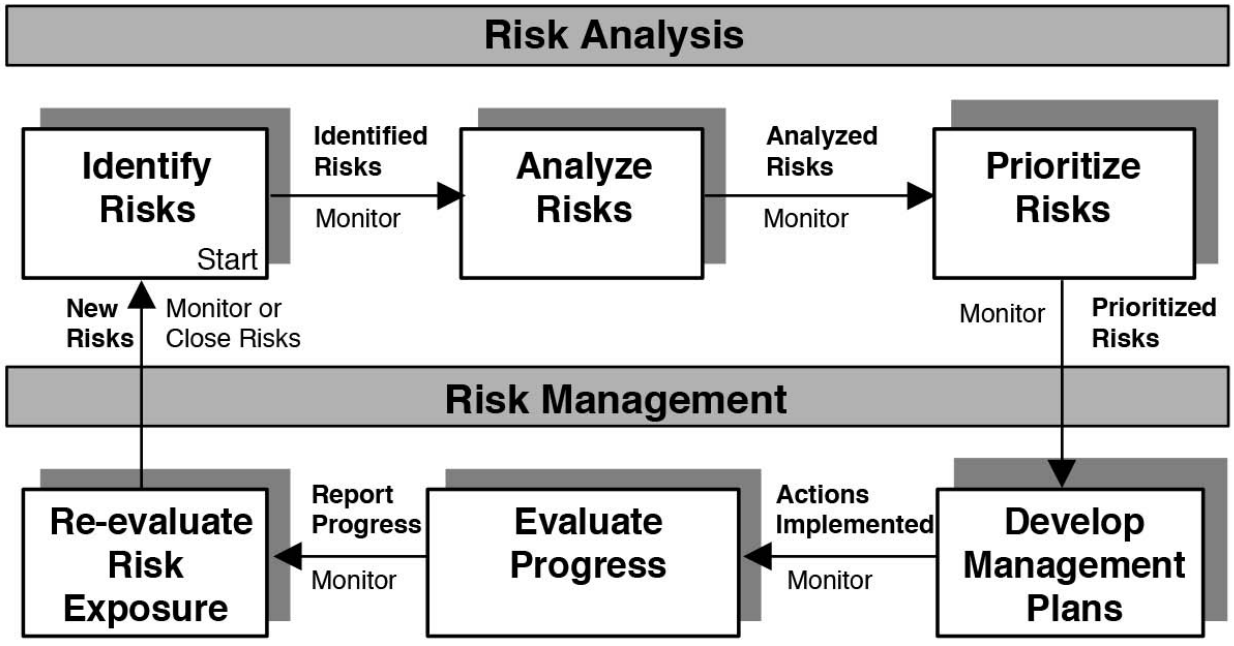
> Risk management is the establishment of procedures and management systems to identify, assess, validate, mitigate, and monitor risks to the organization in such a way as to eliminate them, effectively reduce their impact, or be prepared to respond to them.

As just noted, risk management is not about risk identification alone. In fact, in public-sector organizations, just as in the private sector, leaving the process at the identification level actually opens the organization to additional risks. For instance, if a voluntary organization identified the possibility that a major donor would withdraw funding and then did nothing, the leadership of that organization would be open to criticism that it failed to respond to a real threat and placed the organization in jeopardy. Similarly, if information is received at the senior-management level that a particular program is not being effectively managed and it is possible that funds are being misspent, failure to act upon this risk puts the organization in greater peril of criticism.

Well managed public organizations establish a risk management process to give them assurance that they effectively gather information on risks, assess them, see if their current control framework is adequate or not, make adjustments, review implementation and reassess the situation on a continuing basis. Risk management, therefore, is a continuous process. You do not just do it once. The risk environment is constantly changing. The risk management process has to be predictable and dependable for the organization to make its employees, stakeholders, overseers and governors confident that risk identification is encouraged, even when the news is not good, risks tolerances will inform the level of concern about the individual risk, mitigation will be proportional to the risk in terms of avoiding over-reaction or failure to act, risk mitigation will be realistic and there will be follow-through and clear accountability for managing risks.

Risk management operates in a continuous cycle as seen in the typical risk-management process in **Figure 2.4**. This type of cycle adequately reflects the processes that risk management entails if it is to be successful. Risks should not only be identified, but they should be managed and communicated to the organization. Further, they must be

Figure 2.4
Risk Management Cycle



reassessed on a cyclical basis to ensure that the control procedures established to mitigate the risks are really needed.

Prioritizing Risks: Not All Risks Are Created Equal

Part of this cycle involves the need for managers to make decisions about which risks require action and which ones require nothing to be done. This is often entails judgements and consideration of the organization's overall risk tolerance. Risk tolerance involves a mix of qualitative and quantitative elements and can be elusive. In some cases, for example, developing stress tolerances for bridges, and ensuring quantitative measures are available and verifiable. In other cases, it is less clear. For instance, is media criticism something that a public organization would see as increasing the intensity of a risk. In some cases, e.g., persistent national media attention, the answer may be yes. In others, e.g., a single article in a regional media outlet, such publicity may not be treated the same way. In seeking some sort of quantification of risks, one must weigh the potential loss in terms of resources, program and reputation against the costs of mitigation. For instance, in entitlement programs, the cost of miscalculating eligibilities, where the error is a minor amount, may be such that the cost of preventing the error, or even collecting on an overpayment, may not make it worth trying to control for such a risk. There is no such thing as an error-free program. Still, what is tolerable and why? However, the public-sector context will lead to the careful treatment of risks that are qualitatively significant but not necessarily quantitatively material. For example, small financial or program errors can become major political embarrassments. It also explains why many public-sector organizations are reluctant to engage in formal risk-management programs in the first place: the fear of being exposed to criticism or of embarrassing political leadership, should these risks be communicated to the public.[8] This is the considerable challenge of risk communications, which this text does not address in detail. Suffice it to say that effective public-sector risk management means getting ahead of possible public exposure, not hiding form it. It also means that any risk identification process must have a mitigation and communication strategy associated with it. For example, a department with a budget over-run that may lead to needing more funds will want to get that problem out to stakeholders along with steps being taken to reduce the over-run exposure and acknowledgement that more funds may be needed. The communications element means as well that the political leadership is fully informed, agrees with the strategy and can speak to it. Once again, risk management is a full meal deal.

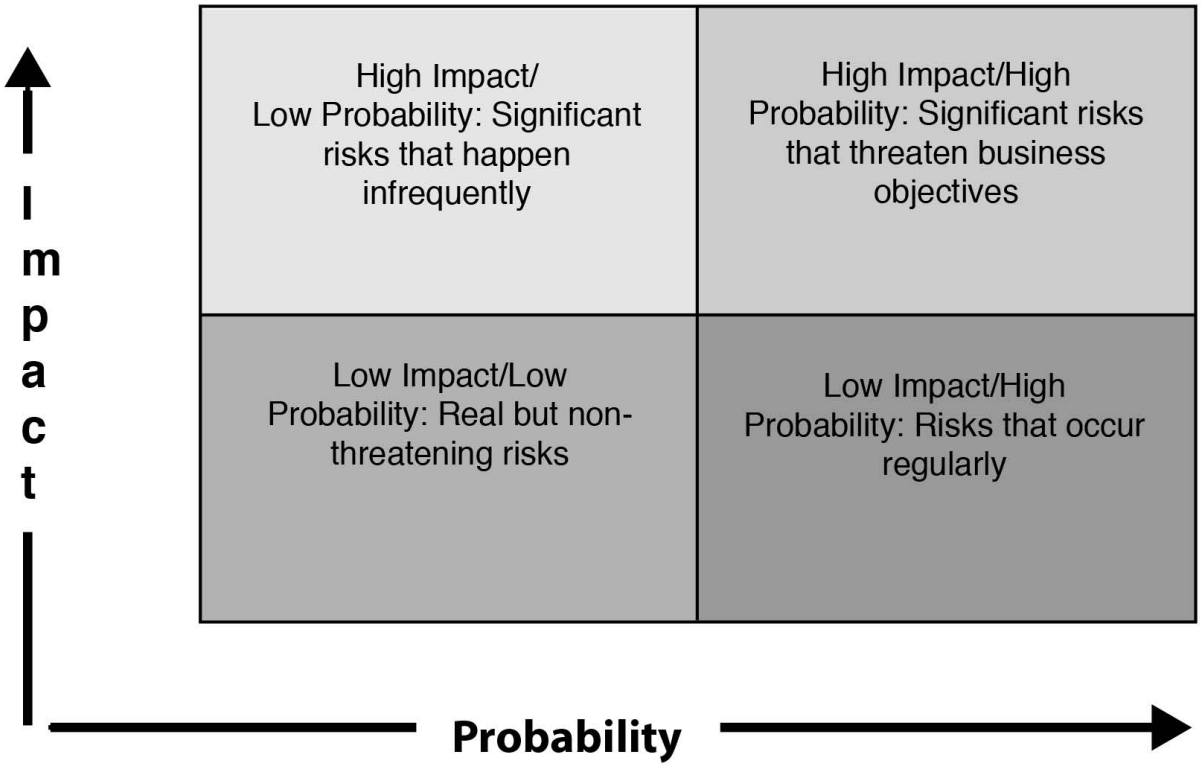
Not all risks are the same. Agencies have to decide which ones are important enough to demand mitigation and which ones are not a significant threat, not pressing, or easily mitigated if they do occur. Two key variables – impact and probability – are the ways to start the risk assessment process. **Figure 2.5** shows how impact and likelihood or probability, interact in developing a risk ranking. A variety of tools exist to assist in making defensible placements of risk in this scale. How they are used will reflect the degree of complexity of the risk challenge as well as the way in which it is used in the agency. Certainly, knowing the methodologies used makes it more understandable to a broader set of users. It also makes it more defensible to critics or oversight bodies.

Because this is an organizational process, many agencies have developed voting processes for senior managers to assign weights to various risks. In some instances, agencies use specialists who propose weighting of risks. Ideally, decision-makers within the agency should own and be capable of defending their weighting of risk. Further, their management responses and development of plans to mitigate risks should be prioritized to the High Risk/ High Probably area.

Managers respond to risks in different ways, based on their impact and probability. The higher the risk is in a quadrant, the more focus and immediate the response. In many cases, however, control systems are key to managing in all quadrants. However, the degree of reporting, oversight and frequency of review of risk will be driven by where it is on this grid. It pays to be confident in the risk identification and evaluation process. The dangers are in either minimizing the risk or in exaggerating it. Agencies take time to learn how to do this. Getting the risk landscape right is often a matter of trial and error. They will have to communicate their assessment of risk within the organization, to their political leadership and to their stakeholders. At the same time, they have to say what they are going to do about them.

8. Lori Bender and Andrew Graham, "Risk Management: Moving the Framework to Implementation" (Ottawa: The Conference Board of Canada, 2004). This study clearly identified a reluctance by senior managers to actually implement a system of risk management. It also examined a number of public-sector jurisdictions where this had been done and the results that were realized.

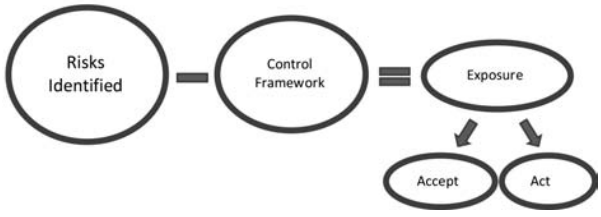
Figure 2.5
Four Quadrants of Risk


High Impact/
Low Probability: Significant risks that happen infrequently
High Impact/High Probability: Significant risks that threaten business objectives
Low Impact/Low Probability: Real but non-threatening risks
Low Impact/High Probability: Risks that occur regularly
Impact
Probability

Strategies to Manage Risks

It has already been pointed out that once an agency embarks on risk management, it has to be prepared to say what it did once it identified and categorized a risk. Needless to say, agencies do this all the time. Risk management provides a more systematic and disciplined platform for response. Our concern with it here is to focus on building controls that respond to risk effectively and affordably. However, as it builds the controls it needs, it has a number of broad responses, some of which obviate the need for increased controls. The objective is to reduce the level of risk exposure or residual risk to a manageable minimum or alternatively, focus special actions on areas of exposure that control systems do not mitigate. This is an important part of all financial management in the public sector. It is illustrated in **Figure 2.6.** The organization's control framework is made up of all those systems, financial and managerial, put in place to ensure that the actual results come as close as possible to planned results. This will involve a set of rules, delegations, monitoring and reporting on activities. When controls work, many risks are either eliminated, quickly identified and mitigated. Risk exposure is the also called residual risk. This is the risk that control does not address. It is what is left over once the control framework is in place and effective. That is why it is important in doing risk assessment to also ask and answer the question: "What are we doing about this already? What are our controls? Are they adequate and working?"

Figure 2.6
Risk Exposure



Once there is an understanding about the confidence in the control framework, the steps to address emerging risk and the residual risk exposure, there are a number of approaches agencies or governments can take to mitigate risk:

- **Accept and Monitor:** Accepting a risk means recognizing that there are factors that mean you cannot reduce it to zero. These factors include the high cost of imitation ("Is it worth it?"), the lack of direct control over complex risks, poor knowledge about the risk, inability to accurately measure the probability of its happening or lack of political will to address the issue.
- **Avoidance:** This is the "Don't go there" option. For instance, an agency might choose to not enter into what it sees as a risky public-private partnership if it lacks faith in the capacity of the partner to deliver.
- **Preventive:** Here is where controls begin to be relevant. Measures that reduce both probability and impact are extensive and will be addressed in the Control Tools section of Chapter 8.
- **Risk Creation:** Seek risk activities strategically to maximize opportunities. For example, fund pilot projects to test out new policies.
- **Transfer:** For a variety of financial risks, finding or buying a partner to insure or cover losses or assume the risk for a return can reduce risk. Buying insurance, requiring performance bonds in construction projects, and changing pensions schemes from defined benefit to defined contribution schemes are examples.
- **Share or Spread:** Find partners to take on part of the risk.
- **Diversify:** Avoid the tendency to put too much authority in one person; instead, find new sources of revenue, or have multiple suppliers that can spread the risk.
- **Hedge:** Buy or invest against future cost increases. Buy fuel in anticipation of price increases.
- **Reduce:** This involves a range of operational, strategic and control options to actively reduce the risk. We will deal with control options below.
- **Cap:** Limit the degree of financial exposure by capping the funds available, or limiting the amount that the program will pay.
- **Create Contingency:** Create reserves to respond to risks. Take operational measures in anticipation of high impact events. Develop contingency and emergency response plans.

No agency or government can manage its risks down to zero. The world is too complex and dynamic for that. There are also costs to risk mitigation that have to be taken into account. The principle of ALARP[9] – as low as reasonably practicable – is a useful one to apply to the amount of risk mitigation that is both possible and affordable. This principle suggests using benchmarks, performance standards, or norms in a given field of practice, as well as legislative guidance.

Good risk analysis and management will drive an agency's control framework. Some elements of control are a given, a requirement of legislation, or internal government practice. However, control is not just about complying with external requirements. Risk management fills in the agency's needs.

In Summary

Accountability and risk play key roles in how public-sector managers exercise their financial responsibilities. They also form the basis for the overall financial management framework, which has three components:

- Public-sector values and context
- Accountability and risk
- Public-sector accounting principles.

Bringing risk and accountability into harmony is a principal objective of good financial management practice. The public-sector context clearly establishes the fact that, for the manager, it is not his money. It is the public's money, working through the legislative authority. The risks of accountability failures require due diligence in getting clarity about who is responsible for what, although that is often not done well, leading to some form of the The Blame Game[10]. Therefore, accountability is a complex terrain for the public sector in that it involves internal, external and horizontal accountabilities. Accountability is about holding multiple players to account for results they committed to provide through a system of rewards, incentives, and punishment. Risk management is about reducing risk exposures in a way consistent with who is accountable for what and can afford what. Knowing the risks, the degree that they impinge on results and then putting in place accountability regimes is the way to balance off excessive control, blame-driven accountability and provide internal clarity.

For the program manager, this means a number of things:

- Probity, a regard for the rules and process that ensure minimum error and compliance, actually does count.
- Public trust in program management and general good management is very important.

9. This concept has its origins in the United Kingdom. A good explanation of its application can be found at http://www.hse.gov.uk/risk/theory/alarpglance.htm

10. Christopher Hood, *The Blame Game: Spin, Bureaucracy and Self-Preservation in Government* (New Jersey: Princeton University Press, 2013).

- Financial information needs to be timely, accurate and usable by all stakeholders.
- Understanding risks enables managers to adjust and adapt as circumstances change.
- Risks need to be assessed, monitored, acted upon, and reassessed.
- In order to have adequate control, you have to know your risk tolerances.
- Being risk smart means a continual outlook for issues, challenges and opportunities.

Chapter 3
The Accounting Framework

Chapter Objectives:

- Understanding why sound and credible accounting practice is a core element of financial management
- Defining accounting
- Understanding the uses and users of accounting information
- Understanding basic accounting principles governments use to create accounting standards
- Applying the accrual principle to recording financial information
- Appreciating the accounting cycle and how financial transactions are recorded

You Are Not an Accountant, but You Need a Good One

The purpose of this chapter is to develop an understanding of what accounting in the public sector entails, what governs it, and the fundamental underpinnings of the accounting process. The application of accounting standards to financial statements will be addressed in **Chapter 11, Financial Statements**. This is because financial statements are a part of the reporting, performance measurement and audit of the overall financial management cycle and therefore covered in Section 4. Building credible financial information and the sound application of dependable accounting practices are vital to good government. Even when the program manager has no involvement in accounting activities in her organization, she depends on it working correctly.

Effective public management operates within an interdependent framework of public-sector values and good management practices, but also having the people, infrastructure and resources in place, in use and, ultimately, accounting for the use of those resources. In the middle of all this is the day-to-day need to know what is going on, to adjust those resources to accommodate changes and still have, at the end of the day, a credible and reliable means of accounting for it. This is built on a solid accounting system. Seldom will managers of programs concern themselves with the mechanics of this system. They will, however, be dependent on its reliability and relevance for their operational and accountability needs. An effective public manager benefits from understanding what accounting can and cannot do. The same manager also has to know the way that financial information is recorded, what standards are applied to discipline in the field, and some of the issues that poor accounting can lead to. An absence of this can foster any number of misunderstandings about the meaning of financial information and to poor managerial decision making. It can, if abused, also lead to fraud or misrepresentation of the financial position of a government.

In addition to these internal management reasons for understanding basic accounting principles, there are external reasons as well. Governments have moved to improve their core financial statements, publishing them more frequently and providing more non-financial performance information linked to their financial statements. Users of such information are increasing. Transparency is increasing. Therefore, public-sector managers, who deal with a range of stakeholders who have an interest in such information, have to understand these external reports and how they come together. They also have to explain them to the public, concerned stakeholders, overseers and their own staff.

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At the heart of the financial management of the public-sector organization will be a sound accounting framework. It is essential for managers within the organization to have confidence in its financial information because they need it to plan, control operations, and account for their activities. It is also central to establishing public confidence in the organization.

The accounting framework has several elements, working together, to support accounting's central role in good financial management:

- **Accounting standards**: In Canada, public-sector accounting standards are set by the Public Sector Accounting Board, an independent body.
- **Accounting policies**: Every government will, through legislation or policy, set out its accounting policies.
- **Accounting cycle**: Every organization will establish a system to record all financial transactions, verify their validity, classify them and produce reports for both internal and external use.
- **Accrual principle**: Revenue earned when goods or services have been provided and their related expenses are recognized when resources have been used.
- **Information for management**: The accounting system will produce information to assist managers to monitor their performance, assure that they are using funds as intended and make adjustments.
- **Financial statements**: Producing standardized financial statements for external reporting purposes is an essential part of the framework. It is the basis of accountability, transparency, reporting to the legislative authority and audit.

Figure 3.1 displays this framework.

Figure 3.1
The Accounting Framework

Understanding What Accounting Does and Doesn't Do

The following characteristics may surprise some, since they debunk the view that accountancy is a set of concise rules intended to apply to all circumstances in the same way. In fact, the following is more likely the case:

- Accountancy and its boundaries are dynamic in nature, always responding to new needs as they arise.
- The boundaries of accounting are blurred and changeable as a result.
- Accounting is both an art and a science. It involves making judgements and adapting information to the demands of the situation while being able to claim objectivity and independence.
- There is an inherent tension between the need to adhere to standards and the need to be flexible in interpreting financial information: governments wander outside standards and boundaries at their peril.

Figure 3.2 Basic Functions of Accounting is the first step in understanding what accounting does.

Figure 3.2
Basic Functions of Accounting

Interpret and record financial transactions
Classify transactions into useful categories and reports
Summarize and communicate information to those who need it

Based on these three functions, accounting is defined by the following characteristics:

- It captures all financial transactions of the organization, verifies their validity, records all transactions in a consistent manner and provides reports.
- The process creates a credible basis for capturing, measuring, and having confidence in the financial framework of an organization.
- Accounting focuses on economic transactions.
- It identifies, measures, and communicates financial information.
- It provides this information to the users of financial information.
- It enhances understanding of what is being measured.
- It provides this information for the purpose of helping the organization reach its stated goals.

Accounting has to be sufficiently consistent to permit economic events, and the information that flows from them, to be compared in a consistent fashion. That is why there is a **chart of accounts**, a standardized set of accounts that payments and transfers have to be coded against. Similar financial events need to be treated in the same way, to allow comparisons to be made over different time periods. Likewise, the accounting policies of the organizations have to be understandable to a variety of outside parties if they are to examine the organization's reports in a useful way. That is why governments will establish accounting policies. It is also why the **notes to financial statements** are so important in that they will outline any changes to accounting policies and their impact of present and past financial reports.

Accounting is not an end in itself but a tool for an organization, and users of information about that organization, to control its internal activities. It allows users to compare performance against plans, to determine the probity and propriety of the uses of finances that have been entrusted to the organization, and to evaluate overall performance. More than anything, it establishes confidence and trust in the numbers and what they mean.

In accounting all transactions are monetized. That, as we will see when looking at the generally accepted accounting principles (GAAP) in this chapter, speaks to both its strength and its weakness. It provides a common language for comparison and understanding: money. This common language keeps track of transactions that occur within an organization and among other organizations. A weakness is that simply stating what has been spent does not necessarily define what has been achieved. It is still good to know what was spent.

Accounting is retrospective in that it records information related to an organization's past financial behaviour. While such information is invaluable in making projections about future behaviour, it is not the only information needed to do so. A note of caution about this: accounting is about actions already taken, but many of those actions in an accrual accounting environment will have a profound effect on future actions and will only be realized in the future.

Why We Need Accounting Information: To Account and to Manage

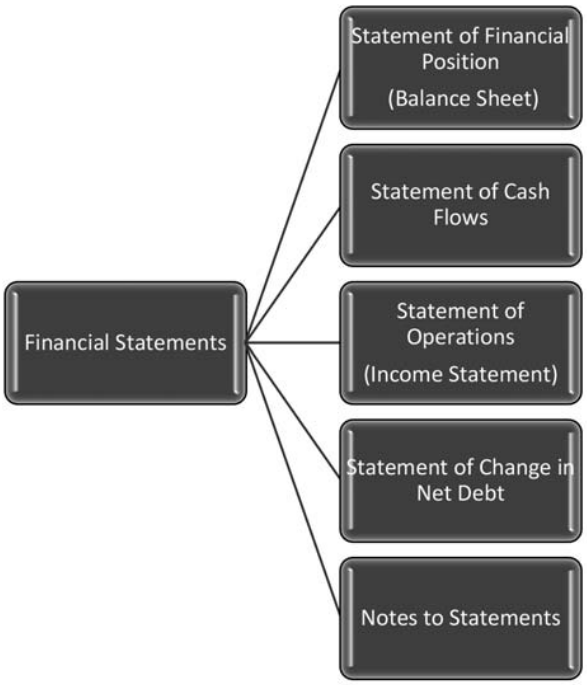
The role of the financial expert in producing accounting information is to observe, screen, and recognize events and transactions, to measure and process them, and to compile organizational reports with accounting information in accepted formats. These are then interpreted and used by management and other user groups. In doing this, two tasks are realized:

- **Management accounting**: This provides support systems, information and analysis to people within the organization to help them manage with the following characteristics:
    - The system informs those inside the organization responsible for monitoring, adjusting, directing, planning and performance evaluation.
    - There is an emphasis on use of information to make future decisions.
    - The timeliness of information is vital to adapt to variances, risks and performance gaps, e.g., weekly or monthly.
    - Information is often detailed, focusing on responsible units and individual segments of the organization.
    - It does not have to strictly follow accounting principles.

- **Financial accounting**: This provides information in the form of standardized report to stakeholders outside the organization that establish credibility for the organization, determine compliance with legal requirements, and report on financial and programmatic results with the following characteristics:
    - The practice produces reports to those outside the organization, e.g., stakeholders, taxpayers, legislative bodies, external auditors, creditors and credit-rating bodies.
    - It provides information that is retrospective with the goal of reporting on past performances.
    - Information is provided that is generally much more summarized.
    - Standardized financial statements are used as mandated by the government it is serving.
    - Accuracy and verifiability of its representational validity is very important.
    - Periodic reporting is based on government policy, e.g., annually or quarterly.
    - It is completely compliant to accounting standards and policies.

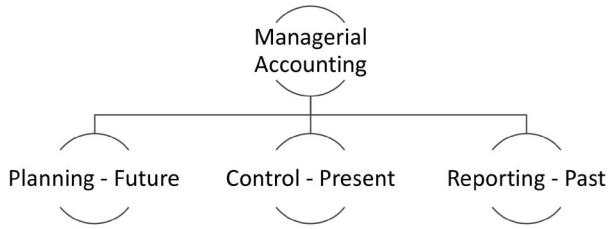
Figure 3.3 lists the more commonly used financial statements that governments use. We will be exploring them in greater detail in **Chapter 11**. Together they form the package of formal reports that governments issue on a regular basis. They also are the main products of financial accounting.

Figure 3.3
Public-Sector Financial Statements



Management accounting has three objectives, all focused on ensuring that the organization achieves its objectives. **Figure 3.4** graphically outlines these objectives: planning, control and reporting. It also shows that the time orientations of management cover past, present and future behaviour. These are all in play at the same time. For instance, in using financial information to determine if the unit is on budget plan for the first quarter of the year, the manager will assess actual performance against the plan. He may well also note that some variance has arisen that he will have to explain or that a spending pattern noted in last year's reports seems to be recurring. Both are part of the reporting requirements. In addition, the manager will be trying to assess whether the variances or new risks that are arising will affect future financial needs or require mitigation such as a program adjustment or the need to seek more funds: past, present and future, all in play for managerial accounting.

Figure 3.4
Objectives of Managerial Accounting



The tools that a manager will use to meet these objectives will vary with the organization and circumstances. At the heart of them is reliable and credible financial information. But, for the most part, the manager will be relying on such information before it is published in the kinds of formal financial statements that we will look at shortly. Some examples of managerial accounting information are shown in **Figure 3.5: Examples of Management Accounting Information.**

Figure 3.5
Examples of Management Accounting Information

- Budget performance: actual against plan – monthly, quarterly
- Variance analysis: comparisons and identification of anomalies
- Cash or budget forecasts and projections
- Costing information
- Performance against targets (financial and non-financial)
- Identification of financial and non-financial risk reports
- Forecasts: cash flow, costing, budget projections
- Cost allocation reports
- Balanced Scorecard/Dashboard of Performance Measures

Users of Accounting Information: Who Cares? Who Needs to Care?

"It's not the economy anymore, stupid. It's the accounting."[1] The evidence from near, and not so near, disasters in both public and private-sector accounting would seem to support greater interest, not just in financial information, but in the accounting practices and assumptions behind it. This is fair and governments have to respond, which they are doing through increased reporting, greater standardization of practice and finding different ways to present financial results. It also means that governments will engage in accounting practices that, while not illegal, are open to controversy. It seems some governments will go to great ends to show a lower deficit by recognizing assets, most notably pension assets, in a way that they do not appear as part of the overall deficit. For this reason, users of government financial reports have to have information structured to recognize certain assets and liabilities. They also will rely upon the judgement of one of the most crucial users of this information, the external auditor of the government's financial reporting. We will be discussing this role in **Chapter 13: Audit: External and Internal**.

Some basic realities with respect to users of accounting information, be they internal or external are:

- There are many different users as **Figure 3.6** shows.
- Their needs and interests will differ, so they will be looking for different information from financial reports or focus on one element only.
- Levels of expertise in understanding terminology and numbers will vary, placing a responsibility on the reporting entity to explain itself clearly.
- Users are free to draw their own conclusions about the financial reporting.
- Some users will not trust the information or its source.
- One person's transparency is another's opacity as some users will not be satisfied with the information provided or its level of detail.
- Users' needs will change over time.
- Users may not have the context within which the information is presented.

Internal to Government Users

Internal users of accounting information include managers who need financial information to control activities and monitor performance. Even within management, needs will vary. Large government organizations have many levels of management, whose needs will be dictated by the roles they play within the organization. Since public-sector managers can be stationed in various regions within the province or the country, their interests in financial information will also vary. Some, such as a line manager running a service centre in a community, will be focused on the performance of a unit and use the information for the control of activities within it. Management at a higher level will be interested in the unit but will want the infor-

1. E. S. Browning and Jonathan Weil, "Burden of Doubtful: Stocks Take a Beating as Accounting Worries Spread Beyond Enron." *The Wall Street Journal*, 30 January 2002, A1.

mation aggregated to broader levels of analysis. They will also want to be able to compare units doing similar work.

Central offices or departmental headquarters will have an interest in the financial performance of the unit in question. For the program manager in the headquarters, financial information will indicate how the unit is performing. For example, if it is one target, how does it compare with other units, how is the manager performing, are there other challenges and risks to be mitigated at an aggregate level? For the headquarters financial advisor who monitors these reports on behalf of the organizational head, the focus will be on whether there are going to be any budget overages or underages, what adequate controls are in place to deal with risks, and how the overall performance of the program compares with past performance and the current year's budget plan. See **Section 3: In-Year Budget Management** for an in-depth discussion of this. There may be concerns that the organization is staying within budget in a current year, especially if there had been problems in previous years. There may a concern that specially designated funds are being spent for the purpose intended, e.g., special recession-fighting funds used for the employment programs for which they were designed. Therefore, they will want to be assured of the accuracy of the financial reports.

Employees other than managers are also internal users of financial information. All employees will have an active interest in the continued viability of the organization and what it means for their own employment. In other instances, they will be interested in the availability of resources for program purposes. This would enable them to make administrative decisions, such as buying more supplies should funds be available. Some will want to be sure that they are not held to account for inaccurately reported information. Such is the nature of the blame game: question the reliability of the information first. The obverse, of course, is to be prepared to account for financial information when anomalies appear.

Figure 3.6
Users of Public-Sector Financial Information

Internal Users	External Users
Program managers	Taxpayers
Senior managers	Legislative authority
Central/corporate officers	Public accounts
Employees	Legislative auditor
Unions	Interest groups
Internal audit	Advocacy groups
Central agencies	Suppliers and vendors
Budget planners	Credit rating agencies

External Users

In the public sector, there is no shortage of external users of accounting information. The following is a representative list:

- The legislative authority that provided the appropriations wants information to ensure that the funds were spent for the purposes intended. Did the money spent achieve its objectives?
- In some cases, specialized committees such as the **Public Accounts Committee** of the House of Commons, for example, will scrutinize financial reports in detail.
- Legislative auditors – that is, those appointed under law by the legislature and reporting directly to it – will have a very strong interest in the financial information because this is at the heart of their mandates. They will also have an interest in the accounting rules and procedures that produced this information. We will deal with their role in **Chapter 13.** At this point, two key roles are played by the legislative auditor: providing an audit opinion on the government accounts, and assessing value for money of the funds spent.
- Taxpayers, whose money, after all, is used to deliver government services, wish to see how that money is spent.
- Interest groups advocate for and critically analyze the activities of the public-sector organization.
- Clients of the organization have a direct interest in the performance of the organization as it pertains to the benefits they receive.
- Suppliers and vendors have an interest in the economic viability of public-sector organizations or in their capacity to meet their financial obligations.
- Government creditors and credit-rating agencies are users of accounting information as well.

Users Have Different Perspectives

Internal and external users of the accounting information that is generated for an organization differ in their use of it in several respects: access, frequency, detail, timing, required expertise and understanding, and response.

Access

Internal users generally have direct and unlimited access to financial information in the organization. This information is available to management on demand to support strategic, tactical, and operational decisions, as well as for monitor-

ing and control of their budget. In contrast, the external users of financial information have limited and indirect access to that information. These people usually rely on the information contained in the formal financial statements as well as reports from internal audits, where they are accessible, and the reports of the external auditor, usually the Auditor General of the jurisdiction. External users do not generally need the same level of detailed financial information as an internal user. The external user will focus on issues like probity, results, and fair representation of the statements. The internal user will focus on performance, risk, and adjustments to changing circumstances in order to meet her objectives.

Frequency

Generally, external users rely on annual or quarterly reporting. Internal managers can demand such information as frequently as their needs for it dictate, even daily. Their needs are much more immediate. They need information as soon as they can get it to make program adjustments.

Detail and Orientation

Internal users of financial information can require reports to be as detailed or as summarized as their needs dictate. External users will receive higher-level information, generally provided in standardized formats such as the Statement of Financial Position (balance sheet). This can be supplemented by additional reporting should it be required, but, for the most part, summary financial statements are at a higher level than what an operational manager would need.

Information for internal users tends to be more current because it is often needed for immediate decision making in the organization. It is used prospectively to make decisions about future actions. For external users, the information tends to be more retrospective. Such information will also be focused on statements of the organization's objectives or results that were published well in the past, so as to permit a comparison of the financial information with the anticipated results.

Expertise and Understanding

Internal users are involved with financial information on a near-daily basis. Their understanding of the nuances or details of the information will necessarily be more complete. So, too, will their appreciation of the background details that explain or condition financial reports.

External users, on the other hand, will rely on information provided by that same organization, but at a more general level. Many stakeholders in public-sector organizations are long-time observers of those organizations, and they develop their own understanding and expertise. Further, public-sector organizations have complex and continuous relationships with those stakeholders who have an interest in the organization. These relationships add context, colour, and depth to their understanding of the financial information. This can result in effective public consultation and long-term relationship building that is vital to a successful working relationship with public-sector organizations.

Response

The responses of internal and external users of accounting information vary. Internal users need information to operate the organization and to make strategic decisions. They also use it to assess performance at both the organizational – "How are we doing?" – and individual – "How are you performing?" – levels. Such information is vital to their understanding of the risks they face and may have to mitigate.

External users want information to determine if the organization is economically viable, worthy of investment through donations, viable as a partner in joint ventures, or if it is complying with the law or meeting its objectives, providing value for money, to name just a few.

Figures 3.7 and **3.8** provide a list of sample questions that users of accounting information might ask. These are just the beginning of the development of many more in this text and in real life.

Figure 3.7
Questions an Internal User of Financial Information Might Ask

- Am I on budget? (Line manager?)
- How does this unit/region compare to that one? (Mid manager?)
- How is the organization performing? (Senior manager)
- What are the risks in our spending patterns? (All managers, financial advisor)
- Does this confirm that our budget assumptions were correct? (Financial advisor?)
- Do we have any flexibility to reallocate? (All managers from their perspectives)
- Are there funds to meet emerging needs? (Financial advisors)
- Does this suggest any changes in our cost assumptions and in our cash projections for this year and coming years (budget implications)? (All)

Figure 3.8
Questions an External User of Financial Information Might Ask

- Are the funds being spent for the purposes intended? (Client, auditor, legislator)
- Are the funds being spent in the manner intended and permitted? (Auditor, legislator)
- Are funds linked to achieve the program objectives? (Auditor, client, public, legislator)
- Are funds being equitably distributed? (Provinces, client groups)
- Are there enough funds for the program and will they all be spent? (Clients, central agencies)
- How does this compare to past years as well as future plans? (All)
- What does this tell us about program sustainability? (All)
- Can I trust these numbers? (Clients, legislators)

Setting Accounting Standards for Government

Accounting standards are standards for financial accounting and reporting developed through a standard-setting process and issued by a recognized standard-setting body. For Canada, that is the **Public Sector Accounting Board** (PSAB), an independent group recognized by the accounting profession and governments to set standards. The work of PSAB is governed by the Accounting Standards Oversight Council, an umbrella body that oversees all accounting standards-setting processes in Canada. It is supported in its work by the Chartered Professional Accountants of Canada (CPA). While this structure appears to be complicated, it does mirror what happens in other countries. The reason is, quite simply, you cannot have a government setting the rules of the game that it is playing. This system offers both some arm's-length objectivity and an assurance that the professional standards of accounting are applied in the public interest.

Accounting standards specify how financial transactions and other events are to be recognized, measured, presented and disclosed in a public sector entity's financial statements. The objective of such standards is to meet the needs of users of financial statements by providing the information needed for accountability and decision making. The PSA handbook, issued by CPA Canada, is the primary source of guidance in the preparation of financial statements.

Governments, in turn, will set out their own accounting standards based on GAAP and the more detailed CPA *Public Sector Accounting Handbook* that the PSAB oversees. Many governments, especially the larger ones, will have a Controller, Controller General or Comptroller[2]. This is the office responsible for overseeing accounting standards and their application in that government. For example, the Government of Canada issues a Directive of Accounting Standards.[3] This is based on the PSA handbook, but provides more detail to departments in the preparation of their financial reports.

Accounting standards are the primary source of generally accepted accounting principles (GAAP). You often hear or see a statement such as "These statements were developed using GAAP principles." What the person using this phrase is trying to say is that they meet the accepted standards for good accounting. Effective financial management depends upon the ability of those preparing financial information to understand the general form and intent of that information and to meet the many needs of users as outlined above. Similarly, while all organizations will prepare their financial information in different ways, a set of basic principles exist for government in Canada that guide how financial

2. There is no material difference between the term controller and comptroller. It has been suggested that the difference arose from an 18th century spelling error that simply stuck. The duties are those of the chief accountant and will vary with the organization. The larger the organization, the more likely the controller will focus on accounting practice and standards setting. The term comptroller is more often found in government, once again, for no clear reason.
3. See https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=32499

information will be created, reported, audited, and generally understood. The users of this information also need to know that what they understand it to mean actually means that. In that, there are certainly elements of *caveat emptor* when the application of the standards is unclear.

GAAP is a general set of principles. It does not provide an automatic formula of reports and forms that, once used, will mean that the financial performance information is accurate or even reliable to the fullest extent possible. Simply adhering to GAAP does not mean the organization is totally honest or straightforward in its reporting. GAAP is simply a basic set of principles for accounting backed up by detailed interpretations provided by standard-setting bodies. These organizations spend a good deal of time trying to offer interpretations and guidance about how GAAP is to be applied in specific situations. Even with that, accountants and financial professionals often use considerable professional judgement in applying them in specific circumstances. The needs of users of public-sector financial information are varied enough that they will take different views of interpretations of both the data and the way in which they are presented. Chapters 10 & 11 will address financial reports based on GAAP.

Generally Accepted Accounting Principles (GAAP)

For all governments, the GAAP forms the basic set of principles upon which their system of financial accounting is based. In addition, in the absence of specific direction, in situations where a government or department have to make an accounting decision where there is no specific guidance, that decision should conform to GAAP as a first test of its validity. They form the basis for the credibility of financial statements published by government. What follows is a detailed outline of the principles.

1. The Entity Principle

In creating financial reports, the first task is to define the unit, or entity that is being reported. The user has to know what these reports refer to and exclude anything that is not related to that entity. For example, in reviewing a Statement of Financial Position or Statement of Operations from the Town of Tillsonburg, we must be able to assume that the information deals exclusively and completely with that entity we know as the Town of Tillsonburg. This may be a simple task, or potentially complex. In the case of Tillsonburg, the parking authority, which is expected to operate as a business, may or may not be included in the town's financial statements. This may seem like a minor issue, but the user has to know. Therefore, financial statements will always explain in the Notes how the entity is defined – what is in and what is out. Financial statements report only the activities, resources and obligations of the entity as defined.

This can become controversial. For some time, there has been a debate as to whether the financial activities of entities, such as schools and health care that are at arm's length, should be included in the provincial financial statements of provinces. These governments have resisted this, as it increases the overall size of the reporting entity, tends to distort an understanding of how much control governments have over these funds once they transfer them, and buries important activities of what is known as the broader public sector in these larger reports. The PSAB has argued that these arm's-length entities are part of the public sector and part of the overall responsibilities of the provincial government, funded by it and directed, through policy and oversight, by it. As these monies flow from the province, they are part of the overall entity we call the provincial government. Over the past decade, the PSAB has gained the upper hand and financial statements of provinces increasingly reflect this notion of the proper definition of the entity. We have to remember that, in such instances, these arm's-length agencies will also produce their own financial statements to meet their own reporting requirements.

2. The Denominator Principle: Money as a Measure

All information in financial statements must be monetized. Accounting recognizes only those activities that can be expressed in monetary terms. Accountants seek objective evidence to value the transactions that they record in the financial reports. Further, no potential income (an asset) nor liability should be recognized until the monetary value is known with some certainty. This will mean that potential risks such as legal suits cannot be recognized in the financial statements until there is some certainty that they will actually lead to a negative judgement and the value of the penalty is reasonably known.

The monetization or cost principle permits an organization to develop an understanding of the value of its assets, using the common standard of money. This applies to assets that it holds in trust or that may not be used or sold, a real issue in government which holds so many permanent assets that are valuable, but not necessarily to be disposed of for gain.

Assigning costs to these involves another, more complex principle of market value versus historic cost.

This last point also points to the restrictive nature of the monetization principle. It is impossible, for instance, to assign a replacement value, a tool often used in trying to place a cost figure on large assets, to the National War Memorial in Ottawa, that reflects its overall value to the country. This is a challenge in public sector accounting, which often holds valuable cultural and historical assets to which a monetized value cannot be readily assigned. Placing a value on assets of this nature is largely subjective, which makes it difficult to recognize them properly in financial statements. Often governments do not even try as doing so stretches credulity and serves no purpose because governments intend to retain such assets in perpetuity.

3. The Cost Principle

The cost principle requires organizations to initially record an asset, liability or equity at its original acquisition cost. Further, there should be an objective record of that cost. However, this principle has been under considerable flux over the past two decades as many assets that governments hold actually increase in value, and simply recording the original cost does not reflect the value of the asset on the financial statements. Using historic cost makes sense and needs to apply to short-term assets and liabilities. However, for assets that can change in value and that may be eventually disposed of by the government by sale of the asset, the cost principle then changes to the fair market value concept.

The tool most commonly used in placing a monetized value on an asset is the historic cost – if that information exists. In other words, you record what was paid for the asset originally. For the most part, this is the accepted accounting standard. If a piece of equipment was bought ten years ago for $100,000, accounting standards will report it at this value, even if a known replacement cost is $200,000.

The notion of historical cost is at the heart of the problems that the monetization principle creates in financial reporting. Many users of these reports criticize this use of historical data. Further, historical data are unrealistic as a full picture of assets that appear on the balance sheet, since they reflect neither the replacement cost, nor potential market value, of the asset. Hence, historical asset information is presented in balance sheets, but it is not really used in decision making because, first, the asset is costed unrealistically, and, second, it is not really available for consumption in the normal sense of assets. In recent years, accounting standards setters around the world have pushed for greater use of fair market value for publicly owned assets such as land and buildings. Successfully done, this provides a more realistic assessment of the value of the asset held. However, arriving at a valuation is a matter of some difficulty. Once again, governments have to weigh the cost of such efforts relative to the benefits of accuracy and transparency.

For governments, fair market value is used for assets such as some property (any property that may be possibly sold), investments and certain liabilities such as the cost of environmental remediation. Methods to determine fair market value will include professional valuations of property, market value reported on investments held, and replacement cost of the asset, especially when the original cost is unclear, lost in history or a decision is forthcoming about whether to replace it or refurbish the asset, weighing the cost and benefit of each option.

4. The Going Concern Principle

This principle states that the organization will continue to operate for the foreseeable future in the absence of evidence to the contrary. Assets are then treated according to what is expected to happen over the normal course of operations and over their anticipated useful lifetime. Thus, they will be expected to depreciate in value or be amortized according to reasonable expectations, e.g., at the rate of 20 percent of this historical value each year for five years, and that the organization will continue to operate over that period of time.

This principle makes it possible to establish reasonable expectations for behaviour and to avoid factoring in unknowns, until they are known. It also avoids the pitfall of valuing assets as if they would be sold off under bankruptcy at lower costs, a possibility for a failing company, but hardly one that would apply to most public entities.

The heart of this principle remains that only what is known can be used in financial statements and that, unless some information is available that indicates otherwise, the organization will carry on.

5. The Conservatism Principle

GAAP holds that the accountant – and, by extension, the organization – will accept the least optimistic financial position. This has been described as a principle by which accountants recognize no gains until they happen, but record all possible losses even before they take place.

Here we see the application of the concept of risk and the approach that financial advisors generally take with respect to it. Risk is, as we saw in **Chapter 2**, a diverse and complex area. Under this principle, risk is treated from a pessimistic perspective, unless information is available to move from that orientation.

For instance, an organization may have considerable accounts receivable arising out of short-term program loans that it provides to its client groups. All accounts receivable appear on the balance sheet as if they will all be collected. The conservatism principle holds that some degree of risk is involved in the collection of these receivables. Hence, treating these receivables as fully collectible probably overstates the asset base of the organization. Historical data may well confirm the fact that, over the past several years, the organization had been successful in recouping only 80 percent of the outstanding receivables arising from these loans. An application of the conservatism principle in this case would be to state probable receipts based on this objective information. In general, accountants want to avoid the use of subjective judgements in making estimates for financial statements. In this situation, however, there is some support both for using historical trends and for taking a more conservative view. The organization's managers may want to improve their performance in recouping loans. The financial advisor, in this case, would have to take a "show me the money" approach rather than accept the highly optimistic and subjective view that they will try harder. Until the organization can show that it is doing better at collecting loans, the truest representation of its financial position will be accomplished by using the historical, conservative view that only 80% will be collected. This principle is meant to overcome what we have come to understand as the **optimism bias** in much decision making.

6. The Accrual (Matching) Principle as the Basis of Accrual Accounting

The matching principle is an important concept of accrual accounting which states that the revenues and related expenses must be matched in the same period to which they relate. Additionally, the expenses must relate to the period in which they have been incurred and not to the period in which the payment for them is made. In general accounting literature, the matching principle normally refers to the matching of revenue and expenses. However, with exceptions, government entities do not generate major amounts of non-tax revenue but are funded through appropriations. As such, the matching principle must take on a slightly different interpretation. Consequently, revenues should be recognized when the goods and/or services have been rendered and expenses should be matched to program delivery outputs of services to the public.

There will be more detail on the accrual basis of accounting later in this chapter. All governments have now adopted accrual accounting as a basis for financial reporting.

7. The Consistency Principle

Once an organization has adopted a set of standards for accounting and financial reporting, it will continue to use them to allow for consistent comparisons between time periods. Organizations have options with respect to how they value assets and report expenses. Once they have decided how to do this, they should continue to use the same methods. When they change them, they have to provide what is a called a cross walk to explain where changes have been made in the financial information in order to permit comparisons. This may mean a restatement of previous financial statements so that the users understand the implications for previous periods.

Users of the financial information should be comfortable that the figures they are looking at mean similar things if they are presented in such a way that they invite comparison. Further, they should be confident that, should there be a change in the accounting rules, this will be fully disclosed and information that enables comparisons will be presented. This means that the organization can be consistent but still change to meet new circumstances or new rules as they emerge.

In the financial statements of any organization, the Notes attached to financial statements need to state the basis of accounting used and also any changes made in that basis since the last reporting period. For example, the following statement appeared in the 2016/17 Public Accounts of the Government of Ontario: "In the current year, the Province changed the presentation of hospitals, school boards and colleges to present third-party revenues of these organizations with revenues of the Province. Previously third-party revenues were netted against the respective sectors' expenses. This change increases the total revenues and expenses of the Province, but has no impact on the annual deficit. The change was made to fully comply with Public Sector Accounting Standards. For comparability and consistency purposes, the prior years' results and the 2016 Budget have been reclassified to reflect this change

in presentation."[4] This is a clear application of the Consistency Principle.

8. The Materiality Principle

Materiality is measured by whether the information being reported is significant to users of the financial statements in making decisions or arriving at an understanding of the organization's financial position. In broader terms, an amount would be considered material if it were substantial enough that an error of that magnitude in the financial statements would cause users of the statements to make a different decision than they would have made if they had known the information. This is intended to assure that reporting entities do not withhold critical information from users. Conversely, trivial or non-material matters can be ignored.

Here, the accountant has to be concerned about how and when financial events are recorded if they will materially or significantly affect organizational performance. This is often a matter of judgement or precedent. In the public sector, it is also a matter of political judgement and, at times, of legal parameters.

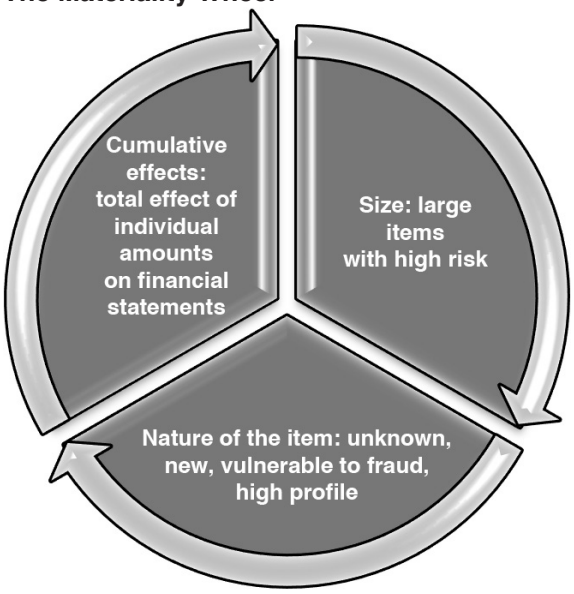
For example, the early estimates documents of the federal government listed every position employed in each department. Eventually, this was not seen as material to Parliament's needs. For a considerable time, the estimates simply reported total salary dollars and total numbers of employees. Even though the number of employees is a highly distorting figure, because departments can use part-time and contract workers and not report them as such, the total number remains an item of great public interest, which makes it material. Similarly, some governments choose to make the salaries of those earning over a certain threshold a matter of public record, the so-called *Sunshine Law.* This practice was initiated because such information was seen as material. It was probably also intended as a way of inhibiting the growth of high-paying jobs in the public sector. As salaries grew, the Sunshine threshold level stayed the same, thereby guaranteeing the government an annual stream of embarrassing questions about the ever-increasing number of public servants above the threshold. Some wounds are self-inflicted.

Organizations in the public sector will apply the principle of materiality differently, depending on the facts and circumstances, as well as the degree of risk involved and the amount of money being spent. For instance, a small organization may want detailed information on staff international travel on an individual basis for its financial reports. Such travel may be unusual for some staff, and there may be a wish to ensure that it is monitored closely. On the other hand, a town may ask that its financial report roll up all staff travel into a single reporting item and note only those travel events with a total cost of more than $500. A provincial department may also want its travel information rolled up, but on the basis of categories such as operational travel for front-line workers, supervisors' travel, or travel by senior staff. The materiality must match the circumstances and is highly dependent on the type of organization.

Materiality is also linked to the financial risks that the organization sees as important. For instance, many government organizations will ask for detailed information and reporting on contracts with private service providers, usually setting a threshold below which these reports are not needed. This threshold, say $10,000, is seen as a risk factor above which more information and control are needed. This is a form of materiality.

Materiality is important to establishing credible financial accounting. It is also pertinent to overall financial management. Managers are constantly making materiality decisions with respect to financial risks, to what they need to be informed about and what may require either a level of what is termed tight control and what merits loose control, i.e., regular monitoring and review. The materiality wheel in **Figure 3.9** shows the factors that come into play in reaching a view on materiality.

Figure 3.9
The Materiality Wheel


Cumulative effects: total effect of individual amounts on financial statements
Size: large items with high risk
Nature of the item: unknown, new, vulnerable to fraud, high profile

4. Public Accounts of Ontario 2016–17: Annual Report. See https://www.ontario.ca/page/public-accounts-2016-17-annual-report#section-4

A Deeper Look at the Accrual Method of Accounting

Principle 6 above is now common practice in virtually all governments in Canada. This was not always so and the maturation of the development of accrual as a basis for accounting and budgeting has only recently been realized. The accrual basis for accounting challenges managers in a number of ways. So, for this reason, we will take a closer look at how it works. This change is more than a technical one. It is part of the general trend in public-sector reforms and modernization. It has important implications for how governments report and view their assets and liabilities. It has enhanced how governments see their future liabilities, such as pension funds, as well as how they manage their capital assets. Accrual budgeting has an impact on how legislators view their role in the approval of budgets, offering both new advantages in terms of fuller costing information and challenges in terms of weakening the closely guarded role of legislative purview over the annual budget allocations of government. For the financial manager in any part of government or its many agencies, understanding the accrual principle is important, not only in terms of that manager's individual responsibilities, but also in providing the best advice on the full cost of any policy or implementation proposal set before decision makers. Simply put, the sticker price of a fighter aircraft fails to inform those making the decision to purchase of the true cost of that weapon. Cash is the sticker price; accrual is the full life cost.

Whether the entity used the cash or accrual basis was once seen as the great divide between the public and private sectors, with the public sector practicing cash accounting and budgeting, and the private sector using accrual methods. That has changed around the world, with the encouragement of the accounting profession and its standard-setters. An impetus for this shift has been the need to have more transparent financial information and to provide that information in a more generally accepted way to a variety of stakeholders, most of whom want more complete financial information than a purely cash system will provide.

In particular, a key attribute of accrual accounting and budgeting is that both provide information that matches costs to the period in which they are incurred. That change is significant to public financial management for a number of reasons:

- The adoption of the accrual basis represents an effort to bring to both accounting and budgeting a totally inclusive approach to identifying costs and revenues, thereby providing a fuller picture.
- Accrual budgeting represents a major challenge to the concept of annualized budgets approved by legislatures, although it in no way reduces the authority of those legislatures.
- Accrual accounting forces a better integration of finance, operations, and strategic direction because of its inclusive nature.
- Accrual accounting demands a higher level of sophistication on the part of public-sector managers and their overseers, be they legislatures or boards of directors.

The adoption of accrual accounting offers a different way of thinking about public resources. The traditional cash basis in the public sector focuses on the annualized approval of funds, their appropriation by the legislature, and the spending of the funds within the same time period accompanied by the necessary financial statements detailing how the funds were spent. Accrual accounting offers a fuller view of costs, thereby encouraging full-cost thinking, as well as longer-term consideration of how resources will be used up, when they have to be replaced, and how to reflect full costing. This is a shift in mentality as much as technique.

Already, the impact of accrual accounting is being felt in many areas of public management. Here are some examples:

- Various governments in Canada and the United States have become engaged in discussions of the sustainability of under-funded entitlement programs, most notably pensions. While experience varies and debate is often tinged with ideological preoccupations, there are genuine issues that only the application of accrual accounting, which provides full funding, would reveal.
- Capital infrastructure is increasingly being seen as a long-term asset that demands attention, rather than one to be depleted and not renewed. The sudden – and surprisingly surprising – collapse of highway overpasses after years of neglect has forced governments responsible to build replacement and repair costs into the life cycle of those assets. Accrual would have made this deterioration more transparent. Only political will can take action on that information.
- Given the application of accrual accounting to procurement of major assets, the true cost of weapons acquisition, including maintenance and future upgrades, as well as training has brought into focus the

> scope of such investment. As the embattled minister of defence said when challenged on the costing, "It's just accounting." He was right about that, but so wrong to dismiss it.

In practical terms, the transition of a traditional cash-based government department into an accrual-based one does not mean the wholesale adoption of a private-sector practice. As previously discussed, unique standards exist in government for accounting in Canada, based on the guidelines set out by the Canadian Institute of Chartered Accountants and the Public Sector Accounting Standards Board. Further, the accrual model has been modified to reflect the products, services, and outcomes of public-sector organizations. As Professor Allan Barton of the Australian National University noted in discussing the relatively early adoption of the accrual basis in New South Wales:

> The business model of accrual accounting did not fit easily into departments which do not sell their services to the public and retain the proceeds but whose activities are funded from budget appropriations, do not pursue profits, own assets or have their own liabilities. So, rather than adopting an accrual accounting system to suit the unique environment of government, the reverse process was adopted of converting departments into pseudo business enterprises.[5]

Examples of Cash and Accrual Recognition

A new computer system budgeted for $8.0 million is being installed in two phases in the 20x1 and 20x2 fiscal years. The computers are bought on account, and $6.0 million will be paid at the beginning of the fiscal year. The balance will be paid at the beginning of the next fiscal year. A cash-based accounting system would display these items as shown in **Figure 3.10**.

Figure 3.10
Example of Cash Accounting

Fiscal Year	20x1–x2	20x2–x3
Expenditure:		
New Computer System	6,00,000	2,000,000

5. Allan Barton, "The Use and Abuse of Accounting in the Public Sector Financial Reform Process," Australian National University, National Institute of Economics and Business Public Lecture, June 2003.

Accrual accounting recognizes the effects of accounting events when such events occur regardless of the time cash is exchanged. Therefore, the expense is recognized in the financial records when it has an economic effect on the organization. When an organization using an accrual basis for accounting sells a good, it recognizes that sale when the sale is made, not when the payment is received. In doing so, it creates an accounts receivable item as part of its asset base. Similarly, when it obtains goods and takes them from a supplier into inventory, it recognizes two things: it has created a liability in the form of accounts payable, and it has also increased its asset base by adding to its inventory. This gives the organization a better picture of its actual financial position.

Using the same computer system as in the previous example, to reflect when the asset would actually be used, we can assume that it has a five-year life cycle. Even though the actual cash outlay is the same as shown in the cash example, the accrual system recognizes the expense when it occurs, not when the money is paid. Hence, an accrual financial report would show the costs of $8.0 million as in **Figure 3.11**.

Figure 3.11
Example of Accrual Accounting

Fiscal Year	20x1–x2	20x2–x3	20x3–x4	20x4–x5	20x5–x6
Expenditure: New computer system	1,600,000	1,600,000	1,600,000	1,600,000	1,600,000

Treatment of Non-Cash Transactions

In addition to recording cash transactions, accrual accounting entails recording non-cash transactions, such as depreciation, provisions, or bad debts. Non-cash transactions have a monetary value and contribute to the organization's financial position, but they do not involve the receipt or expenditure of cash.

For example, a photocopier has a life span greater than a year. In accrual accounting terms, it is a long-term asset. The initial cost of the copier is recorded as an asset in the Statement of Financial Position to recognize the ongoing benefit the copier provides to the organization. The capital cost of using up the photocopier is allocated across the years to the unit or department that uses it. This cost allocation is called depreciation and is recorded as an expense in the organization's Statement of Operations. Note that this does not include the costs of operation: supplies, ink,

electricity, maintenance, etc. These costs are recorded elsewhere. When the photocopier is replaced, the depreciation covers the cost of the asset, and the value of the asset reduces to zero over time unless there is a salvage or resale value, if there is any.

In summary, recording transactions in the correct time period and recording non-cash transactions is designed to allow the true cost of operating activities for a specific time period to be monitored. That is the heart of accrual accounting. The cost of using assets and providing for accumulated leave or outstanding debts is identified and recorded. **Figure 3.12** describes how the Canadian federal government would handle disability benefits for veterans, which are both a current liability and a non-cash transaction, under accrual, as they create a future obligation.

Figure 3.12
Cash and Accrual Treatment of a Liability

Disability Benefits for Veterans

Under modified accrual accounting:

- The government's liability for veterans' disability benefits is not recognized on its balance sheet.
- Expenditures for veterans' disability benefits are recognized in the fiscal years in which the payments are made.

Under full accrual accounting:

- The government's liability for veterans' disability benefits is recorded on its balance sheet. This is the present value of all expected future payments for these veterans' future benefits as a result of past services provided by veterans.
- Payments for veterans' disability benefits are no longer reported as expenditures in the years in which payments are made, but instead reduce the liability that has already been recognized on the government's books.
- For currently serving members, the annual expense cost reflects the net present value of all future payments expected as a result of new disabilities arising during the year.
- Each year, as the liability is adjusted to reflect its current actuarial value, an interest component is added and charged to public debt charges, similar to the recording of the liability for federal employees' pensions.
- Thus one result of moving to accrual accounting is an increase in recorded public debt charges. However, the increase will have no impact on cash outflows.

Source: Finance Canada, 2003 Budget Statement. See http://www.fin.gc.ca/budget03/bp/bpa6-eng.asp

Implications of the Accrual Basis for Public-Sector Financial Reporting

The following illustration of **A Week in the Life of One Government**, shown in **Figure 3.13**, shows how a public-sector organization would record a number of financial events. It demonstrates the differences between cash and accrual means of handling accounts.

Two important points emerge from this comparison. First, the accrual approach provides much more information about the impact of each financial event on the government. The second is that the actual financial condition of the government is better displayed through accrual accounting. On a cash basis, the government is in surplus. On an accrual basis, it faces a deficit. This deficit does not mean the government needs to immediately raise cash to pay down the deficit. Rather, it means that the actual financial resources of the government are displayed, so that its full liabilities over time are shown. That is, the government is not currently in a position to increase spending, as the cash report might suggest.

An example of this is the way in which pension obligations are managed. On a cash-accounting basis, the $30-million pension obligation is ignored until the pension payments are actually made, usually years later. On the other hand, accrual accounting immediately recognizes the obligation. Such recognition has both positive and negative implications. As already noted, it provides a more accurate picture of the full financial obligations of the small government in question. It also forces the government to take this obligation into account as it makes policy and program decisions. On the other hand, such information, especially expenses that will not be discharged for a considerable amount of time and whose value will change over time, may not be relevant to short-term decision making. They may have the perverse effect of dampening the capacity of a government to meet short-term needs. Psychologically, public debate over government expenditures may be conditioned by the presence of long-term obligations clearly booked and taken into account in the calculation of bottom lines. To overcome this problem, such obligations may be managed so that strategies such as special-purpose charges are used or taxes are levied to cover those costs, hence separating them from overall government budgeting. The creation of special funds is often a way to ensure that long-term obligations are addressed without being a drag on regular financial reporting.

A focus on cash only can distort the true cost of government. It also ignores what are called downstream costs

Figure 3.13
A Week in the Life of a Small Government

A series of financial events…

The following examples take place during one week in the life of a small government. The effects of the following five transactions are shown in the financial statements.

1. Corporate taxpayers are required to make tax payments of $100 million to the government, but only $90 million is received. At the end of the week, $10 million is outstanding.
2. The government sells fixed assets for $100 million. The assets had been valued at $100 million.
3. Government salary payments are made during the week. In addition to paying employees $60 million, the government is obligated to provide for their pensions when they retire; employees earned $30 million in future pension rights during the period.
4. The government settles a long-running legal dispute. It agrees to pay $30 million to the plaintiff in two months' time.
5. All the government's borrowings are held in foreign exchange. The exchange rate declined by 2% during the week.

Reporting These Events by Two Accounting Methods

Accrual Accounting Information
(in millions of dollars)

Cash Accounting Information

					Opening	*Changes*	*Closing*
Receipts		**Revenues**		**Assets**			
Taxation	90	Taxation	100	Bank	50	130	180
Asset sales	100			Receivables	20	10	30
				Fixed assets	700	(100)	600
Subtotal	190	Subtotal	100	Subtotal	770	40	810
Payments		**Expenses**		**Liabilities**			
Salaries	(60)	Personal costs	90	Litigation	—	30	30
		Foreign exchange	10	Pension Liability	—	30	30
		Litigation expense	30	Borrowing	500	10	510
Cash surplus	130	Subtotal	130	Subtotal	500	70	570
Bank Balance				**Net Assets**	270	(30)	240
Opening	50						
Closing	180	**Accrual Deficit**	(30)	**Equity and Reserves**	270	(30)	240

Note: Cash accounting would report a $130-million surplus, while the accrual operating statement shows a $30-million deficit. The $160-million difference arises from the following:

- Cash accounting ignores the pension liability of $30 million because it is a future cash outlay
- The asset had a value equal to its sale price of $100 million, which would reduce fixed-assets inventory
- The change in exchange rate increased the value of the foreign exchange borrowings by $10 million
- The judgement created a liability of $30 million that the cash system would not capture until two months later, when the payment would be made
- Outstanding taxes of $10 million remained payable to the government even though they had not been received.

Source: S. Lakshman Athukorala and Barry Reid, "Accrual Budgeting and Accounting in Government and its Relevance for Developing Member Countries," Asian Development Bank, 2003.

of specific decisions made on an annualized basis. It also tends to create spikes in costs, especially capital costs because it costs the product as the cash flows out for construction or purchases at one time, rather than distributing the costing over the use of the item.

Accrual accounting is certainly more complex and difficult. It does, however, have a number of advantages because it provides more useful financial information:

- Accrual is more complete than cash accounting, and provides a full balance sheet approach.
- The scope for manipulation of cash is removed, although it must be understood that accounting or budgeting systems are never fully immune to manipulation.
- Accrual facilitates better-quality financial management.
- Accrual forces full recording of assets and their use, including their depreciation and replacement – something that governments in particular have been remiss in systematically programming into their spending plans.
- Accrual provides the opportunity to change organizational behaviour through anticipating ways to either manage future liabilities, or fully assess the cost of replacing depreciating assets in a systematic way.
- Accrual provides better assessment of financial health and can be linked more easily with organizational performance data.

Just as the accrual system can provide much more information about the actual financial condition of the organization, it can also be distorted through manipulation of some of its key elements. Many of the major private-sector accounting scandals have centred on this very issue. This can happen in two ways:

- Revenue is recognized on the basis of very flimsy evidence. For example, a sale is recorded as income on the company's books even though the actual transaction was only an intent-to-buy agreement that was subject to a series of highly risky conditions.
- The write-off of bad debts or deferral of the timing of certain cost flows is manipulated to make the organization's performance look better in a specified period.

The Quality of Accounting Information

Given the concern for accurate and useful accounting information and the need for standards to be used in presenting and using it, there is a continuing preoccupation with not only its conformity to standards but also the quality of information. Faulty and inaccurate financial performance data can greatly distort internal management control. On the external side they can mislead key stakeholders who have constitutional rights to accurate information. In each case, the credibility of the accounting system and the organization itself comes into question.

The CPA's *Public Sector Accounting Handbook* makes a number of recommendations for ensuring the quality of financial reporting. It points out that the function of financial statements is the communication of information to users. The handbook suggests that the information should have the following qualities:[6]

- **Relevance:** It can be used for managerial purposes and understood for accountability purposes. It applies to the matters of concern to the organization.
- **Predictive value and feedback value:** It helps predict future financial results and cash flows. In doing so, it also provides feedback about past performance.
- **Accountability value:** It helps the user assess the public-sector organization's performance.
- **Timeliness:** For either the internal or external user, it arrives within a time suited to the needs of the user.
- **Reliability:** It possesses the following characteristics that, taken together, mark it as reliable:
    - **Representational faithfulness**: Transactions and events affecting the entity are presented in financial statements in a manner that is consistent with the actual underlying transaction and events.
    - **Completeness**: None of the data necessary to achieve representational faithfulness are missing.
    - **Neutrality**: Information is free from bias that would lead users towards making decisions that are influenced by the way the information is measured or presented. While bias always exists to some extent in most human communications, the point here is that the presentation of information should be devoid of one-sided commentary that advocates or distorts a position.
    - **Conservatism**: Where uncertainty exists about the information, estimates are evidently conservative.

6. A wealth of detailed information is available on Sarbanes-Oxley. For a quick overview, the material in Wikipedia is accurate and general. See http://en.wikipedia.org/wiki/Sarbanes-Oxley_Act

- **Verifiability**: Knowledgeable and independent observers would discern that the information is in agreement with the actual underlying transaction or event with a reasonable degree of precision.
- **Comparability**: The report enables users to identify similarities in and differences between the information provided by two sets of financial statements.
- **Understandability and clear presentation**: Information is clear and simple but with enough detail to make it comprehensible.

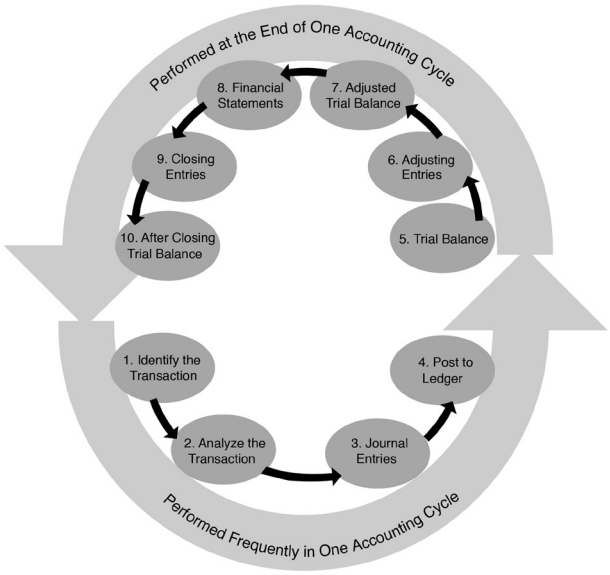
The Accounting Cycle: What Managers Need to Know About How the Mechanics Work

The accounting cycle is a set of procedures that any public organization would be expected to carry out in arriving at a set of accounts that would meet users' needs. It is presented graphically in **Figure 3.14.** In simplest terms, the accounting cycle is made up of the steps repeated in each reporting period for the purpose of preparing financial statements for users.

The result of these steps is that the organization has a set of procedures for analyzing, recording, classifying, summarizing, and reporting its financial transactions. Such procedures, being common to most accounting systems, are recognized and accepted, thereby laying the foundation for the legitimacy of the financial statements.

For most program managers, the accounting cycle takes place without their involvement. The more dependable it is managed, the less the organization will hear about its actions. There will be confidence in the accounting system and assurance that the information and transactions it produces are sound.

Figure 3.14
The Accounting Cycle


Performed at the End of One Accounting Cycle
8. Financial Statements
7. Adjusted Trial Balance
9. Closing Entries
6. Adjusting Entries
10. After Closing Trial Balance
5. Trial Balance
1. Identify the Transaction
4. Post to Ledger
2. Analyze the Transaction
3. Journal Entries
Performed Frequently in One Accounting Cycle

Some of the terms used in this description may not be very meaningful at this stage, but they will be discussed fully in this and later chapters. You may wish to return to this section at intervals and you will find it becomes increasingly clear.

The accounting process is a series of activities that begins with a transaction and ends with the closing of the books, figuratively speaking since most of these activities are taking place within accounting systems. This actually means the closing of the records for the reporting period and the expression of the opinion that all these statements are accurate. This process is repeated for each reporting period. It includes these major steps as outlined graphically in Figure 3.10:

1. **Identify** the transaction or other recognizable event, and prepare the transaction's **source document**, such as a purchase order or invoice.
2. **Analyze** and **classify** the transaction. This step involves quantifying the transaction in monetary terms (e.g., dollars and cents), identifying the accounts that are affected, and determining whether those accounts are to be debited or credited.
3. **Record** the transaction by making entries in the appropriate journal. All entries are made in chronological order. Having a chronological record of financial events enables auditing and verification later on.

4. **Post** journal entries to the **ledger** accounts. The **journal** is the database where all the financial transactions are recorded for the first time. After the transactions are entered in the journal, they are posted into individual accounts known as **ledgers**. The **journal** is a subsidiary book, whereas a **ledger** is a principal database.

These four steps are performed throughout the accounting period as individual transactions occur or in periodic batch processes (e.g., at the end of the day or once weekly), depending on volume and the need to capture the information in a timely fashion.

The following steps are performed at the end of the accounting period:

1. Prepare the trial balance to make sure that the total of debits equals total credits. The trial balance is a listing of all of the ledger accounts, with debits in the left column and credits in the right column. They must be equal. While out-of-balance columns indicate a recording error, balanced columns do not guarantee that there are no errors in the figures within the columns. For example, not recording a transaction, or recording it in the wrong account, would not cause an imbalance.
2. Correct any discrepancies in the trial balance. If the columns are not in balance, look for math errors, posting errors, and recording errors. Posting errors include:
    - posting the wrong amount,
    - omitting a posting,
    - posting to the wrong account, or
    - posting more than once.
3. Prepare **adjusting entries** to record accrued, deferred, and estimated amounts.
4. **Post** adjusting entries to the ledger accounts.
5. Prepare the **adjusted trial balance**. This step is similar to the preparation of the unadjusted trial balance, but this time the adjusting entries are included. Correct any errors that may be found.
6. Prepare the **financial statements**. These generally include the following:
    - Statement of Operations (income statement)
    - Statement of Financial Position (balance sheet)
    - Statement of Cash Flow
    - Other reports as required for managerial accounting purposes.
7. Prepare **closing journal entries** that close temporary accounts such as revenues, expenses, gains, and losses.
8. **Post closing entries** to the ledger accounts.
9. Prepare the after-closing trial balance to make sure that debits equal credits. At this point, only the permanent accounts appear because the temporary ones have been closed. Correct any errors.
10. **Prepare reversing journal entries** (optional). Such entries may be used when there has been an accrual or deferral that was recorded as an adjusting entry on the last day of the accounting period. By reversing the adjusting entry, one avoids double-counting the amount when the transaction occurs in the next period. A reversing journal entry is recorded on the first day of the new period.[7]

This cycle and the creation of financial reports are built upon some very simple concepts: double-entry bookkeeping and the Fundamental Accounting Equation. From these, a range of reports can be created to meet the organization's needs. The following section reviews some of the basic underpinnings of financial reports and their application to the public sector

A Note on Accounting Technologies

The accounting cycle itself is, as will be seen, part of the larger financial management picture. The work that it entails, however, has moved from the era of the finance clerk making and verifying entries to sophisticated computer systems. Such systems have been introduced in governments around the world. Some have been adapted from private sector use. However, one characteristic is common to all. They provide more information, greater integration of financial with non-financial information, i.e., performance information and they do this more quickly. Generally, the routine accounting functions that are described here are integrated into cosmically titled enterprise management systems. They provide a higher level of technical efficiency. They also serve to increase the impact of systems of control, which will be discussed in **Section 3, In-Year Budget Management**.

New accounting technologies have also increased the capacity to generate internal management reports, which will consist of a mix of the formally defined financial statements that are discussed in Chapter 11 and the additional financial and performance information that managers need

7. This material is based on steps that can be found in various presentations. For example, see http://www.netmba.com/accounting/

to monitor progress, detect variance and risk, and take action. Once the inevitable challenges of implementation have been met, commercial software applications have the added benefit of reducing work on reconciliations within the accounting cycle and also automatically generating reports that serve both internal management and external reporting requirements.

Chart of Accounts, Double-Entry Bookkeeping and the Fundamental Accounting Equation

1. Chart of Accounts

A Chart of Accounts (COA) is an accounting tool that defines the structure of the financial recording and reporting system of the organization. The COA, although appears to be just concerned with classifying and recording financial transactions, is critical for effective budget management, including tracking and reporting on budget execution. The structure of the budget – in particular the budget classification – and the COA have a dependent relationship. Transactions are coded and reports generated in a manner consistent with this chart. Without a COA, there is no means to have a proper general ledger system and the reliability and accuracy of the accounting system can be in doubt.

The COA has the following elements:

- A series of accounts that are required to capture financial information called the General Ledger, discussed above, and
- A coding structure for the classification and recording of relevant financial information so that both assets and liabilities are assigned to the relevant accounts.

Getting the transactions assigned to the right accounts in a consistent way is how accurate financial reporting is delivered. Therefore, governments have an interest, through their controllership function, in setting standardized charts of accounts for their departments and agencies. What the program manager may see as a coding requirement when authorizing an expenditure in her budget, the accounting person looking at this transaction will see as an address in the Chart of Accounts to assign that transaction. Tying all of this down in complex public entities involves considerable work and detail.

The organization of the COA mirrors the main elements of financial reports that are to be generated. This whole process of getting to reliable financial information starts with these accounts and the steps taken to put information in them as outlined in the accounting cycle. Therefore, for instance, all asset categories will be organized so that they can be captured under the sub-categories in the assets section of the Statement of Financial Position (See Chapter 10 for more information.) What follows below under Building Blocks of Financial Statements provides more details.

2. Double Entry Bookkeeping

A financial transaction always involves an impact on at least two accounts within the organization's system of organizing its various financial activities. Put another way, for every debit, there is an equal and opposite credit in accounting reports. For example, for every asset there exists a claim on that asset, either by those who own the firm or operate the organization or by those who lend money to the organization. Similarly, the sale of a product affects the amount of cash on hand or accounts receivable that are recorded in the financial reports of the organization. The core concept is that any increase in either assets or liabilities will result in a similar decrease in the other.

Recognizing that the dual nature of financial transactions provided a much more accurate picture of the financial position of the firm, merchants in medieval Venice began using a double-entry bookkeeping system that records each transaction in the two accounts affected by the exchange. In the late 1400s, the Franciscan monk and mathematician Luca Pacioli documented the procedure for double-entry bookkeeping as part of his famous *Summa de Arithmetica.* His work earned him the title "Father of Accounting." By the 18th century, most leading governments of Europe had adopted double-entry bookkeeping in their financial records, following the earlier adoption by business and local governments.

Two notable characteristics of double-entry systems are that

- Each financial transaction must balance each side of the Fundamental Accounting Equation.
- Each financial transaction will result in both the crediting and debiting of at least two accounts so as to balance.

3. Fundamental Accounting Equation

The basic accounting equation is a framework for collecting, organizing and reporting financial information. With this one conceptual tool we can simultaneously:

- Measure how the organization has been doing (income statement).
- Show where it stands financially at the end of the period (balance sheet).
- Summarize transactions with its funders (statement of retained earnings, net debt or fund balance.*)*
- One further extension allows us to summarize balance sheet changes (statement of cash flows).

The fundamental accounting equation establishes the rule that for every action there is an opposite and equal reaction. In more concrete terms, for every increase in the value of one component, there is a decrease in another. It is also the basis for double-entry bookkeeping. Put in non-accounting terms, the equation translates as

What You Have = What You Owe + Your Net Worth

The two accounting entries of double booking keep the fundamental accounting equation in balance so that:

Assets = Liabilities + Equity

In the case of government:

Assets = Liabilities + Net Assets (Net Debt)

The rule of the accounting equation is that both sides of the equation must balance. Although understanding how this equation works requires a fuller understanding of basic accounting than this text can provide, it will be useful to explore some basic principles. This begins with an understanding of debits and credits and how they apply to the equation.

Debits and Credits: The Tools to Balance the Equation

The accounting tool for ensuring that the accounting equation is in balance is the use of debits and credits in each account. When there is a financial transaction, at least two accounts are always affected, with a debit entry being recorded against one account and a credit against another. However, in accounting terms, neither debit nor credit means, in and of itself, a decrease or increase, Rather, whether the amount within the account increases or decreases depends more on location of the account. The rules that apply seem arbitrary, but in the end produce what users of financial information want – accurate financial statements. The convention for the use of the terms is more complex than that and, at times, counterintuitive because it depends on the circumstances and one's perspective on the transaction. The terminology may seem arbitrary, but its use is the bedrock of accounting.

For every account affected by a financial transaction that is recorded by an organization, there must be two components, a debit and a credit, as shown below:

Account X	
Debit	Credit
A debit is an increase in an asset account but a decrease in a liability or equity account.	A credit is an increase in a liability account but a decrease in an asset or revenue account.
All debits are entered on the left side of the General Ledger	All credits are entered on right side of the General Ledger

Relating the Concept of Debits and Credits to the Fundamental Equation

All categories in the fundamental equation can be positively or negatively affected because double entries record both sides of each financial transaction. **Figure 3.15** offers examples of how this works.

Whether a debit or a credit increases or decreases an account balance depends on the type of account. Asset and expense accounts are increased on the debit side, and liability, equity, and revenue accounts are increased on the credit side. The following chart links the accounting equation to examples of three accounts and how debits and credits apply:

Figure 3.15
Linking Debits and Credits to the Fundamental Accounting Equation

Assets		=	**Liabilities**		+	**Net Assets**	
Cash			Accounts Payable			Retained Earnings	
Debit for increase	Credit for decrease		Debit for decrease	Credit for increase		Debit for decrease	Credit for increase

Notice the T-shape in the diagram. T-accounts are a tool to establish the ways accounts are affected by a transaction. Debits increase assets or decrease liabilities and net financial position. Credits increase liabilities and net financial position and decrease assets. To illustrate how this works, **Figure 3.16** outlines a simple transaction and the use of T-Accounts to assess the impact.

Figure 3.16
Debits and Credits: A Sample Transaction

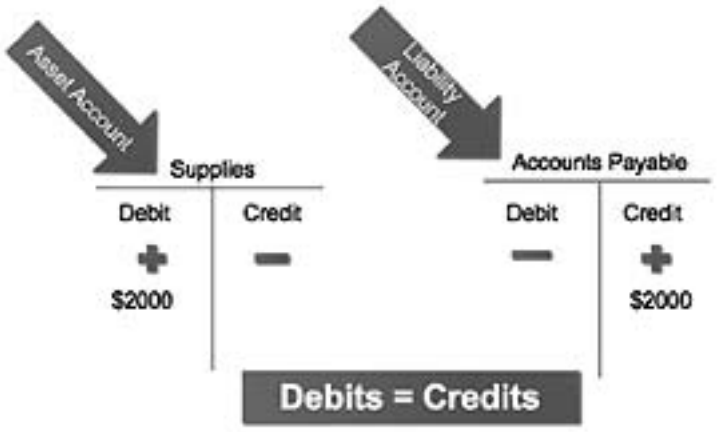
Suppose an agency buys inventory for $2,000. We could just add it to assets, but that puts the fundamental equation out of balance.

	Assets	=	Liabilities	+	Net Assets
Supplies					
	$2,000	=	no change	+	no change

We have not paid for the supplies. Suppose the seller sent a bill? We would record the full transaction as:

Assets	=	Liabilities	+	Net Assets
Supplies		Accounts Payable		
$2,000	=	$2,000	=	no change

To reach this point, T-accounts will be used:



Here are some further examples of typical transactions and the debits and credits and accounts used to record them:

- **Cash purchase**: An office pays a supplier of office supplies at the time of purchase: debit the Inventory or Supplies account under Assets and credit the Cash account, also under Assets. Value of Inventory goes up and value of cash decreases. This is known as a one-sided transaction since it only affects the Asset side of the equation.
- **Goods received, bill to follow**: In this instance, an office ordered and received goods from a supplier who will bill at a later date. Debit the Inventory Account and increase its value by the amount of the purchase and credit the Accounts Payable under Liabilities by the same amount. The value of Inventory goes up and value of Accounts Payable goes up.
- **Pay a bill:** Pay for services you have already received: Debit Accounts Payable and Credit Cash. The value of Accounts Payable goes down and value of Cash goes down.

Working with Journal and Ledger Functions

As noted, the general journal is a chronological listing of all financial events that affect the organization. The general ledger is a summary of this information, organized according to the types of accounts used in the organization's financial reports. The ledger will be organized in a way to capture the building blocks of financial reports, as we will see below.

An account is a category of financial event that the organization deems sufficiently important to list as a separate category that can be captured in reports. For instance, most organizations will want to have a cash account because cash is their most liquid asset.

The primary rule for journal entries – the individual transactions that make up a general journal – is that they must fully respect the fundamental accounting equation, applying double-entry and debit/credit rules. What follows is a number of examples of how this all works. For example, the Hope for Street Kids (HSK) organization buys a $1,200 printer for its office. It has not paid for the purchase but intends to do so when the bill arrives from its regular supplier, within the month. Here is how the transaction will be recorded in the journal:

Assets	=	Liabilities	+	Equity
Account: Equipment		Account: Accounts Payable		
Debit: +$1,200		Credit: = $1,200		

The effect on the overall equation is balance but it has also effectively recorded the full scope of the financial activity. To have simply recorded that a new piece of equipment worth $1,200 had been received would have distorted the financial situation of the organization because it also incurred an outstanding liability. Similarly, the changes in financial condition can take place on one side of the equation only.

Suppose that HSK buys supplies for the office, using its debit card. The value of the goods is $750. The financial events are as follows:

Assets	=	Liabilities	+	Equity
Account: Cash				
Credit: –$750				
Account: Inventory				
Debit: = $750				

Both cash and inventory are on the same side of the equation because they are both assets.

Matters can be more complex. Sometimes, more than two accounts are affected. Suppose HSK wants to buy emergency clothing. It will take full delivery and pay half the cost on the delivery date. It will pay the final bill two months later. Based on the supplier's estimate, the overall cost is $5,000. HSK is reasonably certain there will be no adjustments when it gets the bill, so it can enter the transaction into the journal. Three accounts are affected:

Assets	=	Liabilities	+	Equity
Account: Cash		Account: Accounts Payable		
Credit: –$2,500		Debit: +$2,500		
Account: Inventory				
Debit: = $5,000				

In this instance, both sides of the equation rise by $2,500 and the equation is balanced.

General ledgers take the individual journal-entry information, such as that found in the examples above, and turn it on its side. The value of a general journal is the traceability of the information. All transactions are entered in chronological sequence. Once inside the journal database, the information then moves into many reports, based on the kind of information system that is supporting the

organization and the way the information is coded. It is essential that it be organized into the desired accounts in the general ledger in a timely way. Organizations often have sub-ledgers that are rolled up into the general ledger when needed.

As noted at the beginning of this section, it is highly unlikely that most line managers will ever be engaged in journal entry or in reviewing general ledgers. That is the work of the financial specialists who support the organization. In most organizations, millions of such entries are involved in the basic functions of the organization. For instance, an organization with a staff of 1,500 people who are paid every two weeks would require journal entries to cover each and every pay transaction. Of course, these are now automated and are generally made on a scheduled basis, subject only to changes in status. Feeding those changes to the financial people requires work from the human resources support staff. Once again, there are hundreds of such transactions. These transactions will also be affected by the line manager's needs and behaviours in terms of hiring, approving upgrades, and reclassifications. If money is involved, there is going to be a journal entry at the end of a decision or action.

Major Assets, Liabilities, and Net Assets Accounts

In **Chapter 11, Financial Statements**, there will be detailed discussions of the main financial statements that governments must produce. As a summary, and to link the following detailed discussion, those statements are:

1. **Statement of financial condition or the balance sheet:** This is a snapshot of the financial condition of the government or part of it at one point in time. This provides a picture of the assets, liabilities and net worth/debt of the government.
2. **Statement of operations or income statement:** This is a report on the financial transactions, both cash and accrued, for a specific period of time. This offers a complete picture of all financial transactions.
3. **Statement of cash flow:** This is a report of all cash changes for the government for a specific period of time.
4. **Statement of changes in net debt or net financial assets:** Because governments hold long term debt and its management is a matter of economic and political concern, some governments will offer a separate report indicating the changes in net debt for a specific period of time. However, some governments are in a surplus position with no debt. The status of their surplus is also an important matter of public concern.

As will be discussed further on, all statements will be accompanied by **notes**, which provide information on the basis of accounting and explanations for key financial events. These are an integral part of the financial statements. What follows now is a description of the fundamental elements of these reports. These follow from the basic accounting functions we have already reviewed and are relevant to both to them and the financial reports we will discuss in **Section 4: Reporting and Measuring Performance, Chapters 10–13**.

It should be noted that some governments have recently added an additional financial statement: the statement of remeasurement gains and loss. This statement explains the change in the overall financial position of the entity during the accounting period due to remeasurements related to unrealized gains and losses on specific financial assets and liabilities recorded at fair value, and unrealized foreign exchange gains and losses. This is a more technical type of financial statement and will be addressed, if only briefly, in Chapter 11.

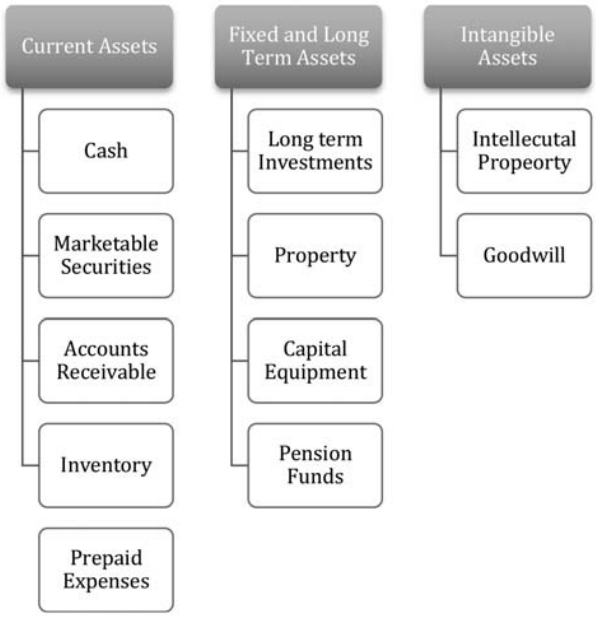
Assets

Assets are resources owned, or in some cases controlled, by an individual or organization as a result of transactions or events from which future economic benefits are expected to flow to that individual or organization. The formal definition under International Financial Reporting Standards (IRRS) is "An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise."[8]

Assets are organized according to their availability, that is, the liquidity or speed with which they can be converted to cash. **Figure 3.17** outlines the various categories for defining assets, and the following section describes them. This does not mean that all assets are in physical form. The test for how they are classified is their availability and their usefulness to the organization in attaining its goals.

8. See www.ifrs.org

Figure 3.17
Asset Categories



Current Assets

Current assets are those assets that can be reasonably expected to be consumed within the fiscal year of the organization in order to meet its needs. They are readily available for use or liquid. There are no restrictions on the number of current asset categories, but those in **Figure 3.17** are the common ones. In some cases, inventories may have a life cycle that extends beyond one year, and how they are reported then becomes a matter of relevance and materiality. For instance, a road-maintenance unit of a city may have three emergency generators in its inventory. These are, by their very nature, contingent items that may or may not be used in a given time period. For the purposes of financial reporting on balance sheets, these would generally be treated more as fixed assets rather than as inventory, depending on their value and expected length of usefulness. How they are recorded would be a matter of accounting policy for the city in question. Such policies are reported in the notes of the annual financial reports of the city.

Cash is money in any form, held either on hand or in financial institutions, that is ready for disbursement at any time.

Short-term marketable securities are, after cash, the most liquid of the assets that appear on a balance sheet. Marketable securities are any form of short-term investment, such as stocks, bonds, readily convertible mutual funds, investments, or treasury certificates that can be converted to cash. Their liquidity will vary, depending on the type of investment.

Many public-sector organizations hold securities for a number of purposes:

1. As a source of operating income from an endowment, which is a restricted fund created to produce such income
2. As a short-term investment to increase interest from reserve or surplus funds being held
3. Increasingly, voluntary organizations receive stock holdings as donations and can choose either to manage them as long-term portfolios or simply to expedite their sales and realize the cash.

Reporting the value of these holdings on the balance sheet requires that they be valued a fair market value. In many instances, this is simply the purchasing value of the certificate, stock, or bond. In the cases of funds such as endowment funds, they will have their own reporting requirements and may not necessarily appear on the general balance sheet of the organization.

Accounts receivable is money owed to the organization or individual in exchange for goods and services it has provided, or for obligations such as taxes, fines, and duties. Receivables can take many forms and are often reported in ways that reflect those forms. For instance, a municipality may mail out tax bills that, taken together, have a value of $3,780,000. That figure could be reported by the city as an accounts receivable item or, to provide greater clarity, as a separate asset category called tax receivable due to its materiality. In accrual accounting, these receivables are recognized, i.e., reported in the financial statements, when the obligation to pay is established.

Non-profit organizations may treat pledges as accounts receivable on their balance sheets. A YMCA, for example, may have pledges receivable, members' dues receivable, and a general category for receivables such as consulting services and daycare fees. In the case of pledges, these are just promises offered or solicited in fundraising campaigns to pay some money at a future date. If the solicitor got a credit card number, then the pledge is a fair bet to be received. If not, then the chances of finally collecting the receivable declines. If the process involves sending out a paper notification and waiting to receive a cheque, the gap between the good intentions on the solicitation and actual receipt of the money is often a wide one, with the organization left holding a receivable but no legal obligation to pay on the part of the donor. Most organizations will treat

pledge receivables with some caution and will only recognize them when they have some certainty of collecting.

The amount of accounts receivable and the length of time that they have been receivable is an important indicator of the financial health of the organization. Accounts receivable aging is a means of analyzing how long ARs have been on the books and will indicate the need to pursue those that have been taking too long to pay or that may, after some investigation, become bad debt that will have to be removed from the books.

Inventories are materials and supplies held for use in providing services or making a product. Inventories have at least two different meanings:

1. Production inventory: Supplies not for sale but for use in the delivery of goods and services (e.g., kitchen utensils for meal preparation in a long-term care home),
2. Equipment inventory: A detailed list showing quantities, descriptions, and values of owned property needed to carry out the operations of the organization (e.g., desks, electronic equipment, and other items typically found in the fixed-asset group).

Some organizations have very large inventories, often with highly cost-sensitive items that are of high value. Matters of inventory management can be important to many public-sector organizations. Some of these, especially with respect to valuation, are dealt with later in this text.

A common distinction, based mostly on cost and the life expectancy of the item, is between supplies, generally treated as inventory and capital equipment, generally treated under long-term assets. The material difference is that, for the most part, equipment is of less value and will be consumed or used within the current fiscal year or near term, while capital equipment can be expected to last a long time, be subject to depreciation and also will be subject to maintenance and betterment costs.

Prepaid expenses include assets that have been paid for and have not yet been used but that will be used within the fiscal year. These include such items as rent paid in advance and fire insurance premiums paid in full at the beginning of a year to cover the whole year. For instance, if the organization has paid for its directors' liability insurance for a three-year period and reports are being prepared for the first year of this policy, the insurance is an asset that is listed as a prepaid expense and, in fact, is being used by the organization to achieve its goals over a three-year period.

Fixed and Long-Term Assets

Fixed assets are those assets that will not be used up or converted to cash within a fiscal year, also referred to as long-term assets. As seen in **Figure 3.17** these assets include categories such as land, buildings, equipment as well as long-term investments or funds reserved to cover future liabilities. In assigning values to fixed assets, it is useful to go back to the GAAP principle on cost conservatism. Hence, accounting generally begins with the cost of the asset not its current value except when, due to the materiality of the value of the asset, that is a more reasonable reflection of value.

Property

This rule of valuation may represent a challenge for some public-sector organizations that are responsible for lands that have never been purchased or other assets that are so old that their original value is meaningless. The move from cash to accrual accounting in the public sector, which will be examined in detail in the next chapter, has brought this issue to light. In general, public entities have to weigh the relevance of placing a cost value on these kinds of assets against the cost and difficulty of doing so. There is also the relevance argument in the valuation of certain public-sector assets: for the purposes of accurate financial reporting, it may be useful to place a value on the legislature buildings in Saskatoon, but these are highly valued buildings of great historical significance to the people of Saskatchewan. Their purchase value will seldom figure into decisions to maintain or upgrade them. Further, it would virtually impossible to determine a fair market value. As such, these assets are seldom recorded.

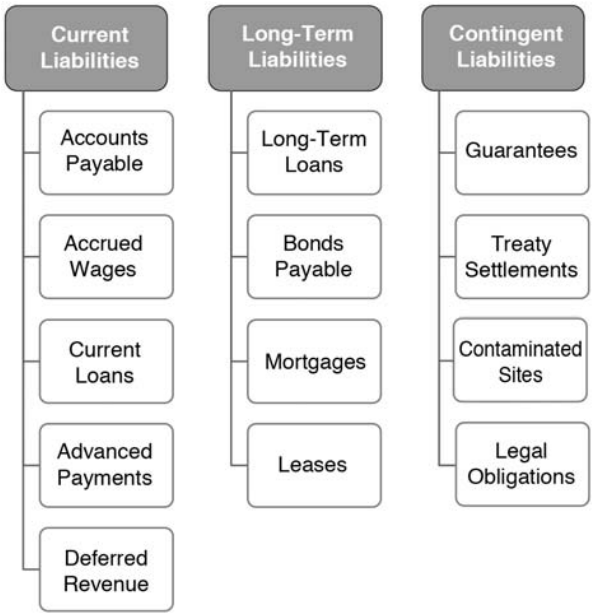
Because of accrual accounting, many long-term assets will be subject to depreciation. While this will be discussed in detail in **Chapter 6, Capital Budgets**, depreciation of assets is an important element in reflecting the changing value of those assets for both the Statement of Financial Condition and Statement of Operations. The principle of depreciation is that all equipment and plant are used up over a period of time defined by the owners and that, at the end, replacement or refurbishment of some kind would be necessary. The accrual system plays an important role in recognizing depreciation expenses in the period in which they are used, not the period that they were paid for. Both plant and equipment are used up over their lives, not all at once. Therefore, the value of the asset at a given time from a financial reporting point of view is the original cost minus depreciation at the rate that is applied to the

particular item. Depreciation, then, will equal the annual monetized use of the item.

Liabilities

Liabilities are legal financial obligations the organization has arising from past transactions or events. They are claims against the assets of the organization. Alternatively stated in the IFRS, a liability is "A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."[9]

Figure 3.18
Array of Liability Categories



Current Liabilities

Current liabilities are those obligations that will come due in a relatively short period of time, usually within the fiscal year for which the reports are being prepared. Generally, they are presented in order of liquidity, demanding cash to discharge the obligation. **Figure 3.18** presents some typical categories, but each organization will define those most pertinent to it.

One category of current costs, accounts payable, represents the amounts that the organization owes its suppliers, creditors, service agents, etc. Wages accrued is the amount of obligation that has been accumulated to discharge staff salaries that have already been earned. This, too, is usually a current account, to be cleared shortly. Current loans are loans that will be paid within one year. Included in this category, or put in its own if it is material, will be the amount to be paid on long-term liabilities such as mortgages within the current fiscal year. Advance payments are payments for services that have not yet been provided by the organization. This is seen as a liability because the asset has not yet been discharged.

Deferred revenues are funds set aside for specific purposes as laid out in legislation, regulation or through a specific agreement. In essence, the government has received money for goods or services not yet provided. This will be eliminated when the funds are sued for the agreed purpose, recognized as revenue and the deferred charge eliminated. An example of this would be a government receiving a sum for brownfield restoration per a development agreement, but not undertaking the work immediately. Once it begins the work, the money can be recognized as revenue, an asset.

Long-Term Liabilities

Long-term liabilities are obligations that are not required to be discharged within the current fiscal year. They include the following:

- Long-term loans are funds borrowed with a multi-year repayment schedule.
- Mortgages are actually loans, generally secured by capital assets, for a longer period of time. As the amount of principal owed decreases each year, this will be reflected in the financial position of the organization.
- A bond is simply an IOU, an agreement under which a sum is repaid to an investor after an agreed period of time at an agreed-upon rate of interest. By purchasing a bond, you are lending money to the institution, company, or government issuing the bond. Such loans normally pay a fixed rate of interest over a specified time and then repay the original sum in full after a fixed period, when the bond matures. They are treated in a similar manner to loans. The net present value of a bond reflects the current cost of future cash flows that are anticipated in meeting its obligations.
- Leases are long-term rental agreements for property and equipment. Often, they extend for many years or for the useful life of the piece of equipment.

9. Ibid. p. 49, IFRS.

Contingent Liabilities

A contingent liability is one that may become an actual liability when anticipated future events occur or fail to occur. As such there is a degree of both certainty and uncertainty to them. However, for governments, there has to exist a probable expectation that the liability will occur and will be sufficiently material to record on the financial statements. Governments may choose to recognize such contingent liabilities as loan guarantees, clean-up costs of identified contaminated sites, treaty settlements (First Nations) and future legal claims. The last item is certainly subject to judgement both with respect to the probability of it occurring and the wisdom of booking a liability in a case that the government will contest its lack of responsibility.

Contingent liabilities have to have some reasonable probability or legal contractual obligations associated with them that would justify posting them in financial statements. Unknown costs or risks associated with a purchase or obligation are not contingent liabilities. Amounts owed for services received but for which no billing has occurred are not contingent liabilities. In this instance, the service has been received – a past event – and the only uncertainty is the timing of the bill.

Governments book contingent liabilities with care. There is a line between such actions and the identification of risks in financial statements. The latter are identified in the Notes without being booked or monetized in the financial statements. The line is the degree of certainty and the ability to actually produce a credible dollar cost of the liability.

Net Debt/Net Assets

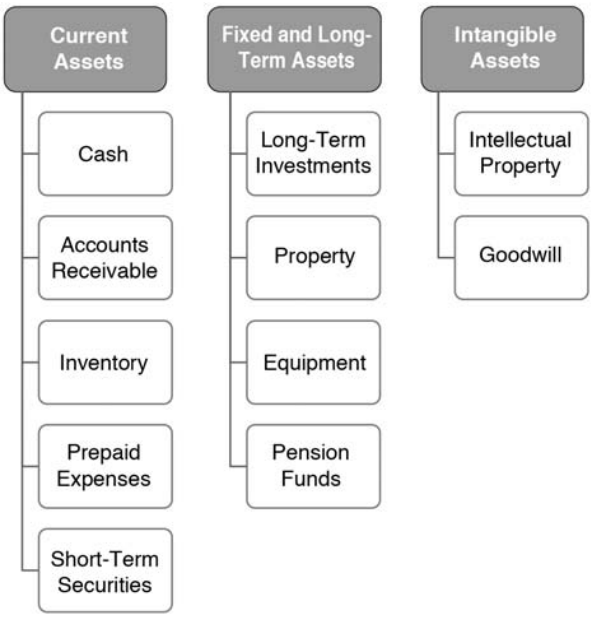
Equity/net assets/fund balance/municipal position shows assets held but not needed to discharge liabilities. **Figure 3.19** sets out typical categories in equity or net assets or fund balance for the private, public, and voluntary sectors. It can be argued therefore that the determination of net worth provides important information about the fiscal sustainability of a government, department or agency. It also provides information on the amount of intergenerational debt or asset transfer that is occurring. High debt means the transfer of that debt to future generations, thereby reducing intergenerational equity.

In the private-sector model, equity represents the amount of funds that should be available for shareholders, or shareholder wealth. When a company is privately owned, it represents the worth of the company to the owner. The other category is income that is earned by the company when it operates profitably but is not distributed to shareholders. This is retained earnings or capital and is treated as part of equity or net assets. These represent the portion of the profits of a for-profit corporation that have been earned over the years and have not been distributed to the owners in the form of dividends. For a government, these are the funds that are held for future use in the form of a reserve or used to discharge debt. Retained earnings arise either from profits or from operating surpluses. Reserves derive their worth from such earnings, from previously held funds or from direct infusions of cash as is often required by law to reduce fiscal risk.

For the public sector, therefore, the equity portion of the financial equation has some different elements than the private sector. These are all called non-financial assets in that they provide future benefits to the entity, but are not readily available for conversation to cash. The key elements that may be included are:

- Reserves, held under varying degrees of restricted use
- Funds – special accounts held for specific purposes
- Net debt or surplus
- Inventory – of a longer term nature
- Tangible capital assets.

Figure 3.19
Array of Net Worth Categories



According to the CICA Not-for-Profit Reporting Guide:

> Net assets, which are also referred to as fund balances or accumulated surplus, represent the organization's residual interest in its assets after deducting its liabilities. In other words, net assets are the net resource available to the organization in carrying out its service delivery activities. Most not-for-profit organizations have some restrictions on their net assets.[10]

In public-sector organizations, the equity section can be divided in many ways to meet the reporting needs of each organization. For example, some municipalities use the term "municipal position" for the equity section of the statement of financial position or balance sheet.

Summing Up

For managers, the world of accounting may seem arcane, more a thing to be obeyed than something of use to them. As emphasized throughout this text, though, the simple reality is that without financial resources not much gets done in any public-sector organization. Finding, using, controlling, and accounting for those resources demand that organizations have a reliable and credible financial and management-accounting capacity. It is the underlying foundation of the management cycle within public-sector organizations.

Accountancy serves many purposes within organizations. Its outputs, be they formal financial reporting or a plethora of managerial information, are examined by many users with many different interests. The need for standards that protect the integrity of the accounting system is great, especially in the public sector where users' interests are varied and where credibility is absolutely necessary and always under challenge.

A manager uses financial data constantly. Understanding how they are derived is useful for a better understanding of them. As consumers of financial information and creators of financial events for which there can be considerable accountability, managers must also play a role in ensuring that the accounting systems they work with are the appropriate ones to ensure meeting the goals of the organization. Executives in public-sector organizations have a responsibility to see that the line side of the organization and the financial specialists communicate effectively to achieve this result. That is part of their role in creating an effective culture that can achieve all of the organization's goals, including its accountability and reporting ones.

10. CICA, Not-for-profit Reporting Guide, Standard 4400-22.

Section 2

Funding Your Objectives: Budgets, Planning, Reallocation and Reduction

Chapter 4
Budget Definitions and Structure

Chapter Objectives:

- Understanding the meaning and uses of budgets in the public sector
- Discovering the different types of budgets
- Reviewing different structures for budgets
- Identifying trends in public-sector budgets and budgeting

This section, **Funding Your Objectives: Budgets, Planning, Reallocation and Reduction** begins with this chapter which provides some basic definitions, drawing a distinction between government-level budgets and the operating budget of a program unit within that government. It also shows how various structural elements of basic budgets inform the user of just how much funding they have and also informs the client and overseer how the funds are allocated. Chapters 5 and 6 will examine planning processes and how they affect budgeting. Chapter 6 will focus on capital budgeting because governments own, operate and build a lot of equipment, buildings and land. Capital budgeting is also important because of the longer life cycle, the high front-end investment and the inherent risks of such long-term commitments. Finally, the Section ends with a look at the process of adapting budgets to changing circumstances, leading to either reallocation of funds or the reduction of funding levels, an inevitable part of budgeting in government.

Aron Wildavsky does a good job of linking policy to budgets: "If politics is regarded in part as conflict as to whose preferences shall prevail in the determination of policy, then the budget records the outcome of this struggle."[1] However, as we shall see, the very word budget has a variety of applications, even within the context of this text. For governments, creating a budget is an important way to make policy a reality. This is when the rubber hits the road. The real meaning and impact of a policy will only become clear when, in the budget process, resources are allocated to implement that policy. It is then that the amount of money to be spent, the number of staff to be hired to deliver the program, or the proposed investment in infrastructure makes the policy pronouncement real and measurable. Our attention will focus on how public managers create and use budgets, on the hands-on work of developing budgets, matching money to policy intent and reallocating budgets when needed. The tensions at play within the budget process engage the organizational culture, the ability of players to both play the budget process towards their ends and succeed, and the capacity to meet program objectives. The budgeting game is an important one for public managers. It is a serious one, but not without its sardonic elements. For a somewhat tongue-in-cheek look at the behavioural dynamics of budgeting, see **Appendix 1, Budget Games People Play.**

What Is a Budget?

A budget is a plan that puts resources in place to implement the goals of the organization. In the public sector, this is the link to policy, legislation, organizational objectives and strategic plans. For much of the public sector, a budget is a monetized plan that establishes spending limits for programs. Finally, a budget is generally time limited, usually approved by the legislature or council for one year, but with a medium budget projection, usually for three years. The approval provides the government and its public administration with the authority to spend.

A budget is the basis for financial control within the public-sector organization because, as a planning and policy

1. Aaron Wildavsky, *The Politics of the Budgetary Process* (Boston: Little Brown, 1974).

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statement, it articulates expectations about the results of the expenditures and begins the control cycle for the responsibility centre manager.[2] As such, it is a useful benchmark for controlling the operations of departments, agencies, hospitals, schools, or voluntary organizations. Control begins with the simple question: "Are we on budget?"

Wildavsky's definition of budgeting contains as clear an understanding of the logic of budgeting in government:

> In the most literal sense a budget is a document containing words and figures which propose expenditures for certain items and purposes. The words describe items of expenditure (salaries, equipment, travel) or purpose (preventing war, improving mental health, providing low income housing), and the figures are attached to each item. A good budget document should include a detailed specification of how its objectives are to be achieved. In the most general definition, budgeting is concerned with the translation of financial resources into human purposes.[3]

Wildavsky's "financial resources" are translated into his "human purposes" by means of his "plan of work." It is through these processes that the public-sector organization accomplishes a number of important objectives:

- A budget translates policy intention into specific activities through the allocation of resources to that goal or to one or more objectives. As we have already noted, this will define just how much is actually done, how many clients are serviced, and precisely what entitlements will look like.[4]
- A budget is a key outcome of the organization's planning processes, once again translating goals and objectives into action.
- A budget sets limits on expenditures to guide managers within the organization. In government, it is dangerous and often illegal to surpass those limits.
- A budget is an economic document that allocates resources.
- Budgetary decisions will set the stage for internal financial controls and effective budget (or cash) management to come into action.
- Budgets will form the basis for performance assessment, evaluation of results and managerial competence through audit, performance reviews and results reporting.

The budget can also be regarded or used as an instrument of public policy and management, as described by Jerome B. McKinney and Lawrence C. Howard:

- **Planning instrument**: Sets goals, priorities, and strategies and coordinates the government/agency resources into an expenditure plan identifying what program or activities will take place and at what levels.
- **Political instrument**: Involves competing interests attempting to influence a government or agency to form policy favourable to them.
- **Social instrument**: Provides a vehicle to grant and deny privileges and disburse burdens and benefits to individuals and businesses.
- **Economic instrument**: Offers powerful potential for affecting the growth and productive capacity of the community and its citizens.
- **Legal instrument**: Grants authoritatively the rights, responsibilities, power, and guidelines that regulate the budget format, timing and process.[5]

A budget performs four functions:

- **Authorization function**: All money spent from the public treasury is subject to legislative authorization or approval from the governing body of the organization.
- **Allocative/distributive function**: The budget determines how much is spent for each program or department.
- **Macro-economic function**: Public-sector budgets affect economic instruments, such as tax rates, and allocate monies to specific programs to improve employment or redistribute wealth.
- **Administrative function**: The budget is a tool to distribute and control resources within the organization according to a specific structure and assignment of responsibilities.

Finally, any budget is the result of a series of decisions and compromises. There are winners and losers. Governments have to make choices. Perhaps it can best be described as the result of a process that takes the needs or wants of its citizens and agencies, grinds these to see what it

2. A responsibility centre is a part of the organization, such as a department or a unit, for which a manager is assigned responsibility. These are often set up in a hierarchical fashion within an organization, with varying degrees of delegated authority to spend and approve expenditures.
3. Aaron Wildavsky, *The Politics of the Budgetary Process* (Boston: Little Brown, 1964).
4. Unless such entitlements are established in specific legislation.
5. Jerome B. McKinney and Lawrence C. Howard, *Public Administration: Balancing Power and Accountability* (Oak Park, IL: Moore Publishing, 1979).

can do – and wants to do – and offers up the end result. There is never enough money and there is no shortage of legitimate demands.

Cultural Dynamics of Budget Formulation

Budgets, their formulation, and their management take place within the culture and context of the public-sector organization. Any understanding of formal budgeting must also be accompanied by awareness that the informal processes within bureaucracies have an important role to play in the ultimate outcomes. For that reason, some emphasis is given to the informal dynamics of budget creation and budget management in **Appendix 1, Budget Games People Play**. This is a somewhat humorous list of bureaucratic ploys that managers can and do use to maximize their resources. It includes some suggestions as to how their superiors might counter such moves. It is a reminder that these formal processes take place in the rich milieu of organizational culture.

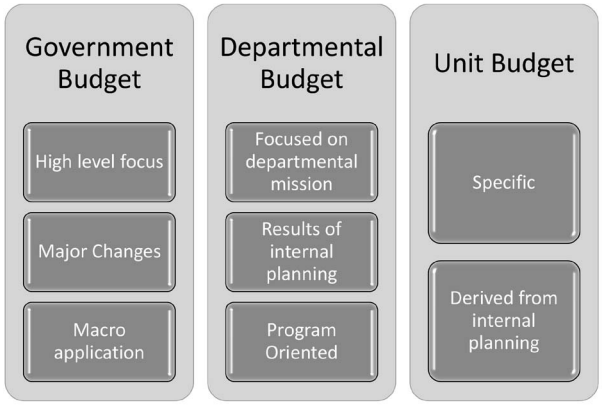
Similarly, this chapter and the next describe budgetary planning cycles and systems. It is useful to know what these are and how they work within the organization. It is also prudent to remember that they take place in the same arena, where power and influence are important. Getting the resources you want to meet your objectives through the budget process is an important aspect of the power relationships in an organization. Holding and controlling resources are key instruments in that game. Remember, there are lots of other parts of the organization that could use your resources. As well, you will depend on other parts of the organization to support what you do so you have an interest in them being properly funded and understanding your access to those resources. A good example is the amount of information technology (IT) support when that is centrally provided within a large government organization.

As we will see in the next chapter's discussion of budgeting process styles, how a budget is formulated – be it top down or bottom up or a variant of both, also reflects the organizational culture. There are clearly advantages and disadvantages to any style. Certainly, there is no right one. Key to success in financial management is understanding how the budget is formulated within your organization.

A Budget Is a Budget … Well, That Depends: Many Uses of the Term Budget

The term budget is used at many levels and for somewhat different purposes even within the same organization. It is important to recognize these distinctions because they may lead to confusion. Budgets, whether at a government level or a unit level, are the result of an iterative process coming from both levels. **Figure 4.1** provides quick schematic of the discuss that follows.

Figure 4.1
Budgets at Different Levels



Whole-of-Government Budget: The annual budget address of the Minister of Finance announcing the budget for the whole government is a high-profile event. This event is often how most people think of public-sector budgets. In the case of federal and provincial governments, the budget is a high-level document in which the minister focuses on the specific issues that are important to the government, those seen as the most deserving of attention: increases to programs, cutbacks, tax and fee changes, new programs, and debt repayment, for instance.

These budgets, while documenting and seeking authorization for annual spending plans, deal with government-wide revenue expectations, marry revenue projections to expenditures across a full range of government programming and tax policy and whether the government will be in surplus or deficit. They are also important economic statements, affecting the country's debt and investment levels, even to the point of affecting the value of its currency.

One useful way to look at this kind of budget is as the legislative budget,[6] the one that, along with specific changes in laws, demands the approval of the highest governance authority. It is also closely linked to confidence in the government. In the Westminster system of parliamentary democracy, all financial votes can be taken as a measure

6. Robert N. Anthony and David W. Young, *Management Control in Nonprofit Organizations* (Homewood, IL: Richard Irwin, 1984), 359.

of confidence in the government. As such, in the Canadian parliamentary tradition, the defeat of a money bill such as the budget constitutes a vote of no confidence and the government falls. Students of public administration will also realize that a government's budget is the result of an amalgam of policy decisions and directions. Budget making, therefore, is policy making.

Agency or Department[7] Budget: Government budget documents signal major changes in policy and taxes. However, they also break down government expenditures by departments. Once the broad direction is set in the overall budget, the details begin to flow out for various departments and agencies. These are the detailed spending plans of government, broken down by department, program or results area. These Estimates documents, as they are called, flesh out exactly where government will spend. But they will hardly be a surprise to the agencies whose plans are outlined there. If the budgetary process is working, and it does in most governments quite well, budget targets, spending authorizations and changes are known in advance of the minister's speech. It is not, however, fully guaranteed that individual units will have full budget breakdowns from within their departments. More worrisome, as well, is the realm of transfer payments to delivery agencies such as regional health authorities and boards of education. Often the details are not worked out, just the global figures. Moving the funds into the right area can involve serious inefficiencies, often leaving individual managers without a formal budget figure at the beginning of their fiscal year.

For instance, a department's budget, contained in the Estimates documents that accompany the Budget Statement of the Minister of Finance, begins to turn the process inwards. The documents define the exact spending plans of an identifiable entity within the public-sector organization, generally a department or agency. The level of detail provided will vary but will certainly be greater than in the overall government budget. Departmental budgets are often broken down into various forms of expenditures, such as staff, capital, and operational costs for the department. They are also budgeted on the basis of the programs that they manage or the results that they will achieve.

It is through a vote of the legislature, referred to as a vote of supply, that funds are appropriated for the department's use. It is only after appropriation is authorized that funds can legally be spent.

7. The terms department and agency are used interchangeably to define those parts of the government that are created, usually in law, to carry out specific functions of government.

Unit or Branch Budget: We now move into the organizational units of a department or agency, where the land of the responsibility centre manager lies. As noted earlier, the responsibility centre is a part of the organization, such as a department or a unit, of which the manager is the individual who is accountable for its budget and its performance. At this level of budget operation, greater levels of specificity are needed. At this point the manager will know her resources levels for staff, spending on supplies and equipment, capital funds and funds for grant and contributions to external bodies.

This is the management budget. The concept of a management budget is a useful translation of larger policy and planning processes into resources available to a responsible manager. It is also the focus of this text.

Distinguishing Public- and Private-Sector Budgets

Companies do not really have to draw up a budget the way that governments do. For them, budgets are targets that have to be flexible in responding to changing market conditions and input cost variation. They are a plan, subject to market fluctuations and adaptation. For governments, a budget is necessary to allocate resources and get the authority to spend.

Planning and programming are very important to both the public and private sectors, but their use differs. In the private sector, a budget is generally a flexible set of planning parameters that can change as market conditions change. For instance, a firm may project annual growth of 15 percent in sales of a specific product, with the budgetary plan to spend an additional 10 percent on labour to meet that anticipated demand. Should demand vary up or down, the firm would respond as quickly as it could to adapt to the change by increasing or reducing its workforce. It could immediately decide to find funds through borrowing or using retained earnings to fund additional hiring. The budget, then, is responsive to market behaviour. A manager would face intensive career vulnerability if he or she failed to respond to such opportunities, as long as they positively affect the firm's profitability. To simply say that a response was outside the budget would not make any logical sense in this context.

In the vast majority of public-sector organizations, however, such a statement would be the essence of good sense. There are several reasons for this. First, the budget is a spending limit, the fullest extent of the legislature's authority to spend funds. It defines the limits of a government's

commitment to a specific policy. But governments are not insensitive to change or unprepared to adapt to changing circumstances. We see this most notably with disasters, both natural and man-made. As we will see, that authority can be altered, even within a fiscal year, to accommodate changes. Spending authorities can also be changed within a fiscal year if policy adjustments are made in that period.

Conditions within the public sector tend to be more stable and less subject to change. That is because demands for services or resources are controlled at the outset. For instance, a college will set a limit on the number of students it will take into a particular program, thereby controlling costs and making them more predictable. While governments organizations will probably have some form or reserves or contingency fund, they are not intended to respond to changes in established program demand, but rather to unforeseen circumstances, such as natural disasters for which emergency funds may be required.

Another point of contrast is in the area of accountability. In the private sector, the bottom line of accountability lies with profitability, share value, and the economic sustainability of the firm. Compliance with a budget is more a form of short-term internal control, subject to fairly rapid fluctuations as outlined above. For the public sector, working within an approved budget is a distinct measure of sound management. This works in two ways: on one side, a public-sector manager who overspends the assigned budget is open to very strong criticism and censure but would also face criticism for failing to spend all the funds available for the programmatic purposes intended. Recipients of such programs, with either a legislative or personal sense of entitlement, expect funds to be spent for the purposes intended, not left on the table at the end of the year.

Another fundamental difference between private-sector and public-sector budgets is the complexity of objectives that a public-sector budget may wish to achieve. A public-sector budget is a major instrument of policy articulation and delivery. Kenneth Kernaghan and David Siegel make this point very well:

> One of the great difficulties in preparing a government budget is that the budget typically has many objectives, not all of which are consistent with one another. In preparing a personal budget, one usually thinks in terms of the fairly one-dimensional problems of adjusting expenditures to fit a relatively fixed income. The complicating factor in the preparation of government budgets is that they must address at least three objectives.[8]

To paraphrase, these objectives are:

- to set macro-economic policy
- to use micro-economic powers to affect people's behaviour, and
- to raise resources needed to fund expenditures.

Cyclical Nature of the Managerial Budgets Past, Present, and Future

As in the Dickens' Christmas tale, the spirits of budgets look back, at the present, and forward, often with reminders of past errors, present challenges and risks that await. For public-sector managers, these three budget realities are in play at all times, as outlined graphically in **Figure 4.2**. The manager has an immediate concern for the management of funds within the current fiscal year. That means the use and control of funds, cash management, and program management. The manger also has to continuously participate as part of the planning process to secure, reallocate or reduce funds for coming years. This involves the organization's expenditure-planning process – the policy-planning cycle or the strategic exercise for development of the future budget. Finally, the manager must account for the past use of funds. This is based on the past budget and the way it was spent. Managers must be able to answer such technical questions as:

- Are supportable financial statements prepared?
- Are they valid? Were legally required reports prepared?
- Were funds properly spent?
- Were there over-expenditures?
- Were funds left unused at the end of the year?
- Do all transactions reconcile so that year-end financial statements can be signed off?

A manager is also accountable for performance, which is results-oriented. In that context, questions such as the following arise:

- Did the funds accomplish the predetermined goals?
- Were the estimates correct?
- Were the funds spent according to plan?

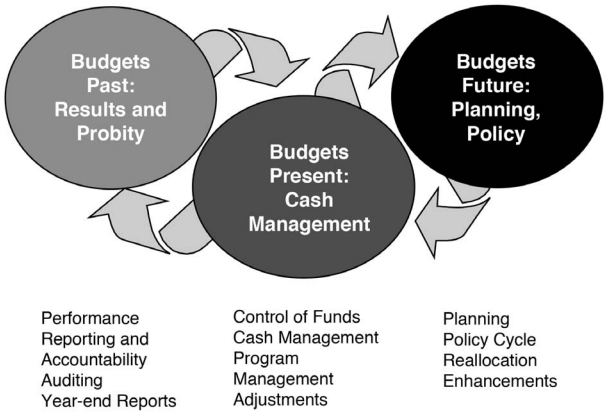
This third budget life – the past – is critically important in the public sector because so much of the budgeting process is *incremental* in nature, with changes made in small

8. Kenneth Kernaghan and David Siegel, *Public Administration in Canada: A Text* (Toronto: Methuen, 1987).

adjustments based on levels of resources in prior years (e.g., an increase of 2 percent per annum with no change in program fund distribution). Many organizations make the majority of their budget decisions on the basis of past performance and allocations. How much was actually used in the past is an important factor. Similarly, except in the event of a major policy shift or program change or major budget cuts, public-sector budgets generally tend to rise in small amounts based on past use and general increases permitted by the central finance authorities.

The past-oriented budget phase focuses on the need to account to legislative authorities, be they the public accounts committee of a legislature, the board of a voluntary organization, or a city council. Increasingly, public-sector organizations provide annual performance reports of some kind. These will contain financial performance information that will be of great interest to the stakeholders and granting authorities. In general, such performance information uses comparative data, such as performance against budget, change from year to year, or possible use of projections.

Figure 4.2
Three Budget Realities


Budgets Past: Results and Probity
Budgets Present: Cash Management
Budgets Future: Planning, Policy
Performance Reporting and Accountability Auditing Year-end Reports
Control of Funds Cash Management Program Management Adjustments
Planning Policy Cycle Reallocation Enhancements

Budget Architecture

Budgets can be structured in different ways to meet the needs of the organization. Budgets can be as complex or simple as the situation demands. Therefore, a smaller voluntary organization might well be served with a straightforward cash budget that shows only revenues and expenditures and is managed by a flexible budget, using only the cash basis of accounting. Larger, multi-departmental governments will require a master budget with both operating and capital budgets linked both to a policy framework and to organizational planning documents, using the accrual basis of accounting and budgeting.

In order to understand the structure of complex budgets, it is necessary to break them down into simpler forms. Often, the more complex budget will be an amalgam of different types of budget architecture. As already noted, budgets in the public sector serve a number of different purposes: policy, planning, resource allocation, and communication. They also operate at different levels within the organization: strategic, departmental, and unit. To meet the various needs of the public, stakeholders, decision makers, budget managers, and staff, budgets can be configured differently. Generally, the forms are not mutually exclusive. Examples will demonstrate how they can be created in layers that meet multiple needs.

One point bears keeping in mind in this regard. Because budgets serve different purposes, they cannot simply focus on just outcomes or results, as is so often the buzz in management for the past decade. Of course, a focus on results is important. You must be able to answer the question: "What are you achieving with this money?" However, in order to get to results, resources need to be lined up and understood in fairly concrete ways. Therefore, inputs such as staff, capital investment and operating money, are key components of getting those results. Here you have to answer the question: "How much do I have to spend and for what? Staff? Equipment? Purchases of Services?" Similarly, the link between results at a societal level and an individual departmental budget is not always clear. There are many factors, many of them well outside of the department's control, that lead to specific policy results. Just a word of advice: do not be afraid, especially if you are the actual budget manager, to take a deep interest in the input or supply end of the budget process. That is where results begin.

Relationship of Revenue Budgets to Expenditure or Operating Budgets

Because the focus of this text is on the financial management of public-sector organizations, the emphasis will be on the expenditure side of the budget. As in the private sector, there is a very close relationship between the revenue side and the expenditure side, but generally at the aggregate or whole-of-government level. Therefore, the relationship between revenues and expenditures is often detached from the day-to-day activities of responsibility centre managers in the public sector. For the most part, governments manage their revenue strategies at the whole-of-government level and then distribute money to

departments or units through the budgetary and appropriations process, thus making expenses the primary focus of the financial manager, especially in larger public-sector organizations such as a provincial or federal government. There are exceptions to such rules. For instance, governments can create revolving funds within departments or for unique agencies. These are funds that are intended to be self-financing, and organizations that use them are generally permitted to retain all or part of their revenue. Similarly, municipalities can tie specific charges or levies to fund particular programs, e.g., road improvements.

In general, government expenditures are not as closely connected with revenues because revenues of government are usually put into a consolidated revenue fund and those funds distributed among the departments or units by the central ministry such as Treasury or Management Board. The consolidated revenue fund is a centrally managed revenue account common to Canadian federal and provincial governments, and serves as the principal operating fund of the government. In principle, all revenues from all government activities are to be placed in this fund. Exceptions abound, but governments generally want to draw as much of their revenue into one central source as possible to ensure that the expenditures it approves are fundable and under a central control.

Knowing the overall revenue situation is vital for governments to make good on their policy and program goals. Their entire expenditure plan is built on a set of revenue assumptions. The revenue budget for the whole of government serves

- To assure an accurate match of revenues to expenditures plans.
- To adjust basic taxes both for revenue purposes and for the expenditure budget.
- To interpret and project current economic behaviour and patterns as a whole to provide an estimate of revenue expectation.
- To adjust other taxes in order to implement policy changes where tax expenditures are used as instruments of such policy, e.g., child tax credits in the federal government.
- To make changes in fiscal policies, e.g., borrowing levels.
- To determine if alternate revenue sources – borrowing, reserves – are needed for current operations or capital investments.

General Budget

The general or master budget of an organization has two main components: the operating budget and the capital budget. In Canada, higher level governments – federal, the provinces and territories – merge the two as capital is expensed when consumed over the life of the asset. For most municipalities, which hold a large portion of Canada's public capital assets, separate capital budgets remain the norm. However, for purposes of understanding how each is planned and organized, we are presenting them separately. Because capital budget planning has such unique elements, **Chapter 6, Capital Budgets: The Infrastructure to Deliver,** will focus on them.

Operating Budgets

Operating budgets describe the resources used to carry out programs within a specified period of time. The operating budget contains the plan for revenues and expenditures for the period, usually referred to as a fiscal year. In governmental terms, the expenditure plan represents the authorized limit of expenditures for the operating unit or responsibility centre.

For the most part, the operating budget is approved for one year, but most public-sector organizations now offer information about future-year plans that have not yet been approved or appropriated but that appear in public-planning reports. Doing so is important as it signals the government's spending intentions in future years, thereby providing greater stability or, in the case of reductions, certainty about the need for adjustment.

The operating budget is also called the **recurrent budget**. This reflects the fact that most operating budgets provide funds for such elements as staff, benefits, supplies, and operating expenses as well as for grants and disbursements on a continuing basis. These expenses are expected to carry on in the same manner from year to year, with adjustments for funds available and for policy and program changes. The term recurrent budget also reflects the generally incremental nature of operating budgets.

Cash Budgets

The terms cash budget and operating budget are often used interchangeably, depending on the form and amount of program information contained in the operating budget and whether the budget is organized on a cash or accrual basis. It is best to think of a cash budget as a stripped-down version of the operating budget. It contains information on planning cash receipts and disbursements or expenditures

only. It may break the information down according to line items that refer to the uses to which the money will be put (e.g., staff costs) but goes little further in providing information about the use of the funds in terms of programs or geographic distribution. It will not contain depreciation or accrual charges such as pensions or accumulated sick credits.

A cash budget is often prepared for a period shorter than a fiscal year. (This forms the basis of cash management as described in later chapters. Cash management can best be understood as that part of financial management involved in the management of budget funds within the fiscal year to ensure maximum use and control of those funds.)

The following are some of the elements of a cash budget that distinguish it from operating and capital budgets.

- The principles of accrual accounting are disregarded in development of a cash budget, often necessitating the conversion of an accrual-based budget to a cash format.
- Instead of matching expenses with revenues where this is relevant to the organization in the period in which they are incurred, a cash budget is concerned with matching cash inflows and cash outflows in the periods in which they are incurred.
- All cash items are accounted for in a cash budget.
- Non-cash items (such as amortization) never appear.

Although cash budgets are important for planning within a budget year (and are referenced extensively in **Chapter 9, In-Year Budget Management**), most public-sector organizations provide operating and capital budget information in the master budget for purposes of external reporting and use the cash budget for internal-control purposes. However, where the organization's concern is on liquidity, the cash budget is very important.

Capital Budgets

Capital budgets contain the plans and resource allocations for capital acquisitions to support the program of the organization. Capital acquisitions cover a variety of goods. They receive treatment different from operating funds because their use is typically a more complex and longer-term proposition than the one-year operating budget process can accommodate. They often involve planning processes with considerable financial risk and resource outlay and are governed by procurement laws and regulations for the purchasing of such goods. Capital budgets involve multi-year expenditure projections with approval for current-year expenditures. Increasingly, governments are providing multi-year approvals to facilitate implementation. And, with the introduction of accrual budgeting, we are seeing the disappearance of separate operating and capital budgets at senior levels of government, although this is still much the practice in municipal governments and parts of the broader public sector such as hospitals and school boards. That is because an accrual budget will recognize the use of the capital asset in the year in which it is consumed. Therefore, the cost of a building with a 10-year life will be distributed in the budgets over the life of that building. In cash budgeting, it would be budgeted as a one-time cost. This does detract, however, from the fundamentally different nature of the capital budget planning process, which is discussed in **Chapter 6.**

Unlike operating budgets, capital budgets focus on non-recurring goods. Buildings are built on a one-time basis, and the capital budget would not automatically contain a plan for another building once one was built. Hence, the capital budget is non-recurring. **The *Ontario Government Municipal Capital Budgeting Handbook*** defines capital budgets in the following terms:

> Capital expenditure refers to any significant expenditure to acquire or improve land, buildings, engineering structures, machinery, equipment and related services used in providing municipal services. These normally confer benefits lasting beyond one year.[9]

Land and buildings are well-known capital goods. Increasingly, information technology infrastructure is a part of capital budgets. Determining what is and what is not treated as a capital item is a matter of policy within public-sector organizations. Often cost thresholds are set such that the purchase of a good is treated as a supply item if it costs less than, say, $500. Governments will treat computer peripherals of lower cost, such as printers, as a supply item to be purchased from operating funds and not a capital item but will require that the computer itself and the infrastructure (services, networks, etc.) be treated as capital goods. The key features for deciding are:

- Is the good to be used over more than one year?
- Is there a higher level of risk given the nature of the investment?
- Is the good material enough to be treated as capital?

At times, the nature of the good being acquired determines if it is to be treated as a capital good or simply as a supply item. Goods that are highly visible, with high potential for

9. Ontario, Ministry of Municipal Affairs and Housing, *Municipal Capital Budgeting Handbook* (undated).

abuse, are often recorded as separate capital items rather than simply as supplies. For example, an organization may choose to highlight certain relatively inexpensive capital items, such as GPS units, because they may be subject to abuse and the organization wants to exercise greater control over them. Putting them into capital also makes them part of the organization's inventory and subject to greater scrutiny. On the other hand, a potentially higher-cost item, such as paper for computers, may be treated as a supply item and not taken into inventory.

What You Can't Budget For: The Role of Reallocation, Reserves and In-Year Authorizations

It is great to hear that a budget is a plan. The reality is that once a plan hits the real world, it has to adapt to change, to the unexpected and the complex realities of implementing public programs. As well, you cannot budget for the unexpected such as natural disasters or major shifts in economic conditions. In some areas, governments simply cannot set money aside for such changes as they are not planned for, are unexpected and the exact cost of them is unknown. In others, most notably for disasters and emergencies, governments need to build in flexibility and redundancies to adapt. It is seldom the case that they will successfully budget for emergencies. That does not mean they do nothing. For it is certain that emergencies will occur. Being resilient in operational and technical terms means that some resources actually do have to be set aside for planning, training, equipment and monitoring. Further, governments can and do budget for certain events, based on a projection of probability and severity. This risk-based approach is often informed by experience. Therefore, municipalities will budget for a certain anticipated level of snow removal based on their experience. However, they are hard-pressed to budget for extreme weather occurrences such as floods or hurricanes. Reasonable budgeting for emergency planning is a normal government activity. However, responding to the severity of events means governments have to have a way to replan their plan, to reallocate funds in an emergency.

There are a number of measures that governments can take to budget for disasters. These include:

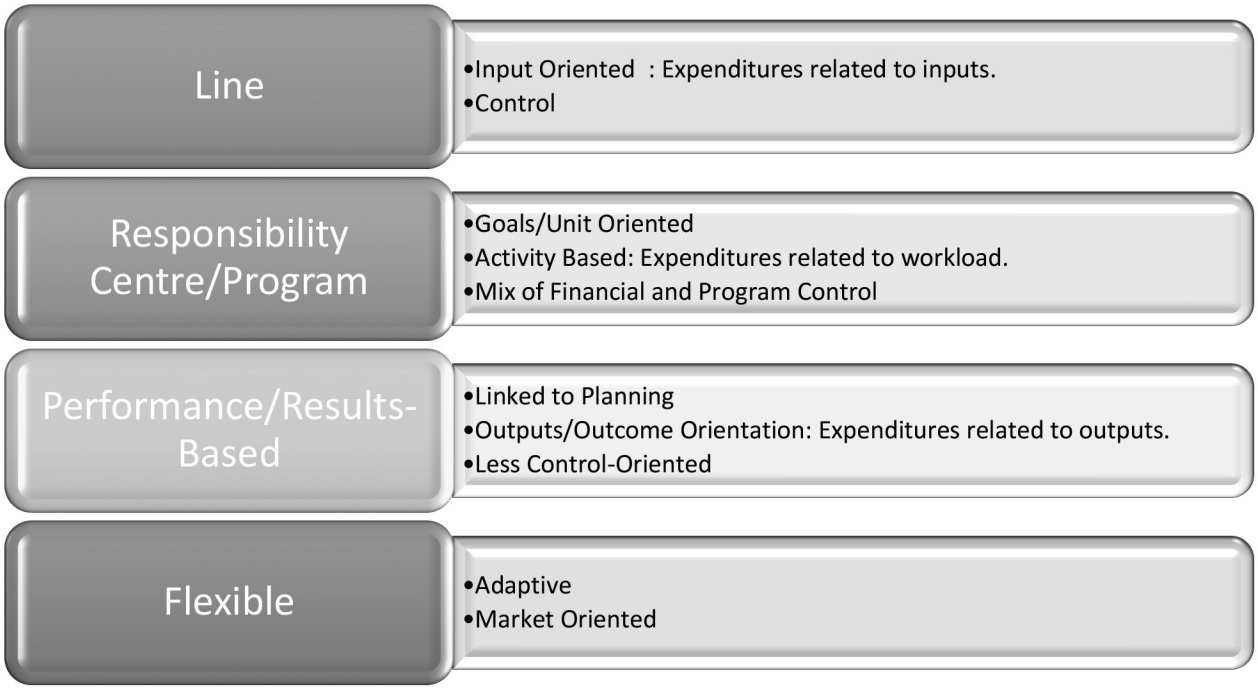
- Budgeting for planning and monitoring to improve response capability and reduce response costs
- Budgeting for stockpiling of equipment and vitally needed items, such as vaccines, creation of special restricted reserve funds for disaster response that can accrue over the years, managed as a separate fund and replenished after use, and
- Creation of general-use contingency funds.

Who controls these funds and how transparent they are is a matter of budgetary and cash management dynamics within a government or agency. For federal systems, such as Canada and the United States, there is also a legislated system of emergency support for extreme events. In the end, especially when a new form of disaster arises for which there is no anticipated response, governments will also have to retrospectively fund the response. Seldom do governments hold back when public safety is severely threatened. They then have to go back and find funds or approve new ones through their regular budget management or through special means. As we shall see, most governments have ways of approving funds outside the annual cycle. This is a good thing, especially when the unexpected happens.

Structure of Operating Budgets

Budgets can be structured in a number of ways, depending on how the information is to be presented and the purposes for which the budget is created. **Figure 4.3, Types of Operating Budgets** provides a schematic of the different types of operating budgets. Similarly, elements of each budgetary form can be used in conjunction with each other. It is common, then, to see that program budgets, centred on the programs offered, also have elements of line-item budgets, which are designed around the functional uses of the funds. These are not mutually exclusive, but help understand the budget, its use and impact, in a number of different ways.

Figure 4.3
Types of Operating Budgets



Line-Item Budgets

The line-item budget is one of the easiest to prepare and one of the most useful in the context of a specific program, project, or small organization. The financial information is organized according to types of expenses or cost categories. These are often referred to as inputs. These generally focus on staff, supplies, rentals, and contracts, all of which can be characterized as costs of operations. These line items are standardized into what are called object codes so that they are used in a similar way across the organization. An object code is a numeric code, part of the overall Chart of Accounts structure of the statement of accounts used to identify the nature, purpose, or object of each financial transaction. These codes are used in all budgeting and accounting systems for consistent reporting purposes. They also form the basis for the structure of journal entries in the accounting process, as discussed in Chapter 3. To illustrate, **Figure 4.4** shows a simple line-item budget for the mythical Killaloe General Hospital for fiscal year 20XX.

Figure 4.4
Simple Line-Item Budget: Killaloe General Hospital

Object Code	Budget
100. Salaries	$8,000,000
200. Supplies	2,000,000
300. Rentals	250,000
400. Professional fees	750,000
Total	$11,000,000

Line-item budgets are good for control of inputs and accounting for how funds were spent. This budget will tell the manager or stakeholders how much is being spent on what item of expenditure. These amounts are known as inputs in that they identify the categories of resources (staff, supplies, etc.) needed to do the work. Since it uses common objects or object codes, it also permits inter-budget cost comparisons between programs or organizations with similar functions. As a good example, if all hospitals used the same object codes or line items, an interested observer would be able to determine if the Killaloe Hospital had a higher ratio of staff cost to overall budget than another similar hospital.

The line-item budget is also simple to prepare. The accountability in these budgets is focused on the money approved for the individual items and how it is spent. This is known as dollar or input accountability. In the public sector, the line-item budget is often subject to great scrutiny. There is heavy reliance on conformity with the limits set by each item and how monies may or may not move from one item to another.

Line-item budgets are often criticized for their focus on inputs and not on the results or outputs of the organization. This is fair criticism, up to a point. While it is popular to say that managers should focus only on results, it is a considerable challenge to achieve any results without proper management of the necessary inputs. Hence, getting the funds straight with respect to such elements as how many people you can hire is essential in accomplishing the results desired. No level of great results will be acceptable to the public, the external auditors, or the authorizing governing bodies if the inputs are poorly managed.

As important as it is, the line-item budget contains very little information about what the money is being spent for in terms of the program or public goods that are being delivered. It does not offer any information regarding the activities and functions of the program. For example, even though we know what is being spent on staff costs at the hospital, we have no idea what results those costs achieve relative to health outcomes. They could be providing mental health services, cancer care, or administrative services. We will see that there are better and more informative ways to link budget information to what is being done (program) and what is being achieved (performance). It starts with the responsibility centre budget.

Program or Responsibility Centre Budgets

This type of budget assigns resources to the operating unit, zone, area, or specialized program within which it is being spent. This is often identified as a responsibility centre. A responsibility centre is part of the organization, such as a department or unit, for which a manager is assigned responsibility, usually with spending authority for the assigned budget as well as responsibility for its proper use**.** These centres are often set out in a hierarchical fashion within an organization, with varying degrees of delegated authority to approve expenditures.

In a program budget, the focus is on the programs and program elements that represent the activities for which the funds are to be spent. In **Figure 4.5**, we see the 2005 budget of the Killaloe General Hospital, which has been realigned along the lines of how it defines its main programs or services:

Figure 4.5
Responsibility Centre Budget of the Killaloe General Hospital

Responsibility Centre	Budget
01. Operating Room	$4,000,000
02. Laboratory	1,000,000
03. Radiology	1,000,000
04. Patient Care	2,500,000
05. Outpatient Care	1,500,000
06. Administration	1,000,000
Total	$11,000,000

This budget offers useful information about what the funds are being spent for – that is, the programs – but very little information about how they are being spent in terms of inputs – the line items. It also provides no information about what is being achieved with the funds. That reflects in a small way the major challenge of all budget formats. They have to provide useful information, but there is a limit to just how much information can be provided in a given document. In addition, different users want different information. For example, the responsibility centre manager for Radiology will find this useful, to a limited extent, as it shows the overall budget figure for her unit. However, she will want to know more than that. What are the component parts that make up this figure? In this instance, as we will see below, this can be reconciled through a functional budget, which combines both.

From the perspective of decision making, it is vital to know how the funds are to be distributed across programs, some competing and some complementary. Much budget decision making is concerned with the allocation of limited resources among competing program demands. This format of budgeting enables both the decision makers and the public to identify the relative program priorities within this hospital.

Governments will try to provide as much specificity in a program budget as possible. Often program areas will have a number of activities, really programs themselves. **Figure 4.6** shows how on a general program area of a municipality, public safety and leisure services breaks down its program budget information.

Figure 4.6
Program Budget of the Bureau of Public Safety and Leisure Services

Bureau of Public Safety and Leisure Services FY 201x-1y		
Program	**Program Element**	**Amount**
05 – Public Safety	0501 – Fire Protection	3,500,000
	0502 – Police	5,000,000
	Subtotal	8,500,000
06 – Leisure Service	0601 – Parks	2,000,000
	0602 – Library	1,000,000
	Subtotal	3,000,000
	Total	11,500,000

Functional Budgets

A functional budget is a format that combines the line-item budget with the responsibility centre or program budget to provide a more complete picture of the distribution of budget resources within an organization. It has the benefit of providing a better basis for comparison among responsibility centres within the organization. Of course, one has to be sure that oranges are being compared to oranges. For instance, a responsibility centre, e.g., Operating Rooms, may have high salary costs, while another, e.g., Administration, may be lower. That may reflect the labour intensity of the work or the size of the unit, as well as the different costs of the professional and support staff in each unit.

The functional budget delivers a better understanding of what funds are to be spent for. It combines information about inputs and responsibility centres or programs that are being funded. It also permits a certain amount of cross-program comparison within the overall budget of the organization. **Figure 4.7** displays the functional budget of Killaloe General Hospital for 2012.

Figure 4.7
Functional Budget of the Killaloe General Hospital

Responsibility Centre	100. Salaries	200. Supplies	300. Rentals	400. Professional Fees	Total
01. Operating Room	3,250,000	250,000	50,000	450,000	4,000,000
02. Laboratory	550,000	350,000	25,000	75,000	1,000,000
03. Radiology	450,000	450,000	0	100,000	1,000,000
04. Patient Care	2,000,000	400,000	0	100,000	2,500,000
05. Outpatient Care	1,200,000	175,000	25,000	100,000	1,500,000
06. Administration	475,000	325,000	50,000	100,000	1,000,000
Total	7,925,00	2,000,000	150,000	925,000	11,000,00

Flexible or Rolling Budgets

Budgets are put together on the basis of assumptions about the future. For the most part, they are treated as fixed for the period that they cover. This enables the manager to establish effective cash control within the period, to assign responsibilities and authorities to spend with some certainty for individual managers, to control work and volume flows to operate within the known budget and to use the budget as a tool for assessing organizational and personal performance at the end of the period.

Such certainty is not always possible, especially for organizations with variable demands or those with a greater market orientation. For instance, a local museum in a small community that is run on a volunteer basis and depends on its program for visitor income may have volatile income flows. This also holds true for those that are totally revenue-dependent in volatile markets, such as those that depend on community fundraising. Often there are too many variables to permit the certainty of a locked-in budget with both secure funding and a certain level of service. These organizations are likely to have no really solid indicator of demand, or else their mission directs them to take in all those who demand their services without the kind of program controls that government can use to restrict access.[10]

10. In fairness to governments, sudden shifts in program demand are usually accommodated through contingency or emergency funding or requests for additional funding authorization from the legislature. In addition, some fluctuating programs are structured as special funds with the capacity to use residual cash reserves in a year when demand is high and then retain income during years when it is low.

Two types of factors can change budget assumptions and may require the use of the flexible budgeting approach:

- **Shifts in demand or workload:** In many instances, public-sector organizations structure their services so that they are open-ended, available to anyone or to all who meet some form of eligibility test. Such is the case with many entitlement programs. As noted, for some larger organizations funded with some certainty by a central government, these fluctuations can be accommodated. In others, contingencies can be built in. For a smaller public-sector organization, such fluctuations can have a major impact, either by seriously encumbering its ability to meet its mission and objectives or by forcing it into a new round of fundraising.
- **Shifts in revenue flows:** Smaller voluntary organizations are much more sensitive to sudden shifts in revenue, especially organizations that lack secure funding or cannot manage sudden changes through credit. Major fundraising efforts may fail. Often, fundraising is sensitive to economic fluctuations and resources may fall just as a sudden downturn in the economy creates greater demand for the organization's services.

For these reasons, the flexible budget may be the most reasonable way to hedge against such uncertainties. The flexible budget is built around a series of "what if" scenarios. These are hypothetical situations, usually involving either changes in demand or sudden fluctuations in revenue. For the most part, however, a flexible budget, when used as a formal management tool, will focus on the impact of demand or workload changes. The organization will want to have some sense of certainty with respect to funding before committing any funds for the coming period.

Fixed and Variable Costs in Determining Budget Fluctuations

To fully understand the basis of flexible budgeting and the application of "what if" scenario building, one has to understand that not all costs or inputs respond to change in demand in the same way. The concepts of fixed costs and variable costs have roles to play in several parts of this text, so introducing them at this stage is a useful way of discussing how to build flexible budgets.

Fixed costs are costs that do not change as volume changes within the relevant or normal program range. An example of a fixed cost is the rental of a building or use of an information system. It is assumed that these will generally accommodate normal fluctuations in activity. In extreme cases, such as a natural disaster, this may not be the case, but for budget purposes, the normal range would apply. Therefore, for an organization whose mission is providing breakfast meals to pre-school and school-age children in a certain neighbourhood, the rent for the hall and kitchen facility will not change with volume of service.

Variable costs are costs that vary in direct proportion with volume. For the breakfast program, each meal provided is a variable cost item in that feeding each additional child will add to the costs. That is, the larger the number of children who come for breakfast, the higher the costs of such items as food, milk, and supplies to prepare the food.

The organization used in this example, **Hot Meals for School (HMS),** has to budget very carefully at the best of times. It has to think through the implications of changes in demand. It will take in any child who comes through the door for a breakfast because this is its mission. It gets only a small grant from the municipality and raises funds through a variety of means well known to volunteer groups: holding bake sales and yard sales, selling raffle tickets, and seeking donations constantly. As a relatively new organization, it has only a couple of years of experience. Experience is probably the best way to determine the potential for fluctuations and their impact on variable costs. These two years have been up-and-down years for the local economy, so the first year saw an average of 300 children getting a breakfast every school day; in the second year, when a major factory suddenly closed, 450 were arriving each day. The Board of HMS went to work and found more donations on the fly to meet the higher demand. Now it wants to become more systematic in its budgeting so that it can make a good business case for help. It turned to flexible budgeting (see **Figure 4.8**) as a tool.

Figure 4.8
Hot Meals for School Flexible Operating Budget for 2006

Number of Breakfasts Provided Daily[1]			
	300	**450**	**600**
Expenses			
Salaries	$ 50,000	$ 50,000	$ 50,000
Supplies[2]	180,000	270,000	360,000
Rent	14,400	14,400	14,400
Other	5,000	5,000	5,000
Total expenses	249,400	339,400	429,400
Revenues			
Municipal grants	200,000	200,000	200,000
Fundraising	75,000	125,000	125,000
Total revenue	275,000	325,000	325,000
Surplus (deficit)	$ 25,600	$(14,400)	$(104,400)

Assumptions:

1. The service is provided 200 days a year.
2. The cost per meal is $3.00 with little flexibility for economies of scale. In this sense, an economy of scale would be getting a lower price for buying more supplies, perhaps a bulk buy, but with the small scale of the operation the price per meal does not get cheaper as you buy more.

As the cost of meals changes – the only real variable cost in this scenario – costs rise and the potential for a deficit arises. At this stage, this kind of what-if scenario building helps organizations realize their vulnerabilities. Conversely, they can also establish a sense of the normal range, in terms of both demand that can be accommodated and the need to seek more revenues.

Flexible budgets force organizations to deal with both sides of the equation – revenues and expenditures – and to determine where they might try to cut costs or develop contingencies should the more extreme cases come to pass. They are also a signal to an organization that it may want to launch new funding efforts to shore up support for its program. Finally, they may suggest that there is a need for an organization facing these fluctuations to develop contingency funds to reduce the impact of changes. For instance, in this case, it can be readily assumed that the surplus, which would build up when intake is low, would be held or invested and available to manage the demand when it is high.

Funds in Budget Structure

Governments will want to make sure that the funds budgeted are spent for the purposes intended. In particular there will two types of restrictions to ensure that resources are protected from reallocation, where that is not desirable:

1. **Line Restrictions:** In this instance, the government will prohibit the transfer of funds from one line item in a budget to another. For instance, the transfer of salary dollars to another other use may be forbidden. Similarly, the transfer of non-salary dollars for, say, the operating budget line item will also be forbidden. As we will see in **Chapter 9, In-Year Budget Management**, some transfers can be permitted within a fiscal year, but they cannot alter the budget for coming years. For instance, within the operating budget, funds might be able to be moved from consulting services to training.
2. **Funds within the Budget:** A fund is an accounting entity with its own separate set of financial records for recording and reporting assets, liabilities, fund balance, and changes in fund balance. A fund is a budget within a budget. It is usually created to protect resources for a specific purpose and to ensure that they are not used elsewhere in the government spending. Funds are generally long-term parts of the budget.

Fund accounting involves an accounting segregation, although not necessarily a physical segregation, of resources. How such segregation takes places is a question of budget construction. Movement of resources among funds often is restricted by specific rules or requires specific authority – perhaps legislative permission – to make changes.

Funds are created for a restricted purpose. There may be legal restrictions on the use of the funds. Similarly, organizations may want to ensure that a specific program or element of it is isolated, and to an extent, protected from others and that there is adequate reporting on each fund at the end of the period, for a variety of reasons. Creating a special fund also serves some useful public accountability purposes:

- A special fund creates greater transparency for the designated purpose, so that stakeholders can identify the funds allotted and track their use.
- Funds protect and segregate special purpose spending from reallocation as part of the general fund or consolidated revenue fund of a government.
- Funds may also direct a specific source of revenue to pay for the activity being funded.
- Funds can provide some level of risk mitigation in the case of funds such as legislated reserves or contingency funds. This is an application of prudence in budgeting, a principle which holds that some degree of contingency is needed to deal with unexpected events.

For example, the Expenditure Budget, 2013–2014 of the Government of Quebec identifies 35 different funds within its overall budget. They are found in many of the ministries. They total over $9 billion in spending, ranging from the Green Fund of $448 million to the Natural Disaster Assistance fund of $12 million.[11]

Types of Funds

Funds are created for different purposes and governed by different rules. The great distinction is whether funds are restricted or unrestricted. An unrestricted fund is one whose assets may be used for any normal purpose. Normally, the general operating fund is unrestricted. Organizations that structure their budgets entirely on the basis of funds must have a general or operating fund for all expenditures that do not fit into clearly defined categories. Further, funds tend to limit flexibility within a budget, so having a general fund creates some scope for moving funds to meet emerging demands. These general funds are also used for the day-to-day operation of the organization.

A restricted fund is one whose assets are limited in their use. Restrictions vary across organizations. Some exist because of the nature of the activity or program. For example, the commercial operations of a municipality, e.g., its parking authority, may be managed within a restricted fund. **Figure 4.9** shows some of the different kinds of funds that public-sector organizations can use.

Figure 4.9
Different Types of Funds

Fund	Definition
General Fund	Consists of general revenue sources such as taxes, fines, licences and fees.
Special Revenue Fund	Consists of resources that are restricted for special purposes. Examples would be special funds from other governments or organizations for special program funding, e.g., infrastructure improvement.
Debt Service Fund	Consists of resources used to repay long-term general obligation debt.
Capital Project Funds	Consists of resources restricted for construction and acquisition of capital facilities.
Fiduciary or Trust Fund	Account for assets held by the organization in a trustee capacity.
Endowment Fund	Usually a donation for specific purposes that is intended to earn income for the organization or university. Often governed by separate governing board.
Program Specific Fund	Special purpose program, e.g., Millennium Fund, which manages its own resources and does not have to return those funds at the end of the fiscal period. To be used for intended purpose only.

Off-Budget Funds and Expenditures

Off budget expenditures refer to financial transactions that are not accounted for in the budget but are still part of the resources used by the organizations. While taking public expenditures and revenues off budget suggests dishonesty and lack of transparency, there are many legitimate forms of government resource commitment that do not appear on what would be seen as a traditional budget. That is changing as the impact of accrual accounting and budgeting is being increasingly felt. Similarly, governments can create a range of entitlements and enterprises that do not draw funds from general revenues, but are either contingent liabilities or self-funded enterprises that populate what is called the broader public sector.

Examples of off-budget expenditures include:

- Activities of government enterprises, especially those that do not draw appropriations for their activities
- Specialized self-financing entitlement programs such as pension plans, which would also mean that

11. Government of Quebec, Expenditure budget, 2013–2014. See http://www.tresor.gouv.qc.ca/fileadmin/PDF/budget_depenses/13-14/3-Special_Funds_Budget.pdf

governments cannot access the accumulated surplus of such plans, a matter of contention over the past decades
- Loan guarantees or credit provided by a government, which can take the form of direct government loans or guaranteeing private loans
- Tax expenditures, such as special allowances for individuals or companies, which reduce revenues to the government, and
- Public-private partnerships in which a government assumes risk but uses private financing arrangements, thereby not drawing down appropriations.

Being off budget does not mean being out of sight. Governments, especially as they seek to deliver services in different, more cost-effective ways, will look to third party entities as well as public-private partnerships to get the work done. The challenge is understanding where the boundaries are and what has to be kept on-budget and what can be off. Accrual budgeting challenges that ability to conceal, deliberately or otherwise, major contingent liabilities such as pension fund shortfalls in future years. Therefore, the exact cost of this contingent liability should appear in future budget documents.

The challenges of off-budget expenditures are transparency and control. Political control, the ability to direct the public purpose of the expenditure, is less direct than for the budget. This may or may not be a problem, as, in some instances, entities are taken off budget to reduce political control of their operations. That being said, political control is essential in a democracy. It has to be achieved through other means. Accountability for expenditures is often weaker when expenditures are off budget. This is due to the relatively lower transparency of those expenditures. This has been a consistent criticism of the use of tax expenditures, for instance.

Linking Resources to Results

A challenge that many governments are addressing is to link the budget as a financial statement with the strategic business plan of the organization, marrying the top line of strategy with the bottom line of the budget. Some of these concepts have succeeded, and some have not. Some continue to evolve. In the public sector, however, one sees a greater trend towards attempting to link financial data to results. The challenge in the public sector, quite unlike the private sector, is that these results are seldom financial themselves.

Two types of budgets that attempt to build better links between budgeted funds and the results they are intended to achieve are zero-based budgeting and performance or results-based budgeting.

Zero-Based Budgeting

Most budgets are incremental in nature. The current year's budget is often based on adjustments to the previous year's budget along with the additions and subtractions arising from program or funding changes. Using the example of the Killaloe General Hospital, it can generally be assumed that, policy changes aside, its program will continue from one year to the next with relatively little change. Creating a budget thus becomes a matter of making small adjustments to salaries, supplies, etc. Often this is done within the context of some overall budgetary cap that will govern the overall bottom line.

Of course, it is possible, and at times, absolutely necessary to start from scratch in creating a budget. This is known as zero-based budgeting. A conceptual approach to budgeting that emerged in the 1970s, it achieved its moment of fame as the new solution to all budgeting problems and then went on to become just another set of letters in the pantheon of failed quick fixes – ZBB.

This form of budgeting assumes that all expenditures will be thoroughly reviewed on an annual basis and subjected to intense scrutiny. Decisions about their desirability will be made afresh. With ZBB, no assumptions about carrying on can be made. A formal system is put in place to scrutinize existing programs, which must be approved before they can carry on. In theory, the decision makers are operating with a starting budget of zero and building a new spending plan on an annual basis. Managers must defend their current resources before they can argue for more. This involves putting in place a budget-planning process that carefully examines all expenditures on a line-by-line basis. It also assumes that the organization can create a challenge function, with people in the organization and in consulting firms, to advise the decision makers about the validity of the assumptions made by those asking for the funds. Often this will pit the finance function against the operational or line function in the organization. However this comes about, ZBB assumes that there is ample analytical capacity and time to determine if each expenditure is valid.

The table in **Figure 4.10** compares the characteristics of ZBB and incremental budgeting with respect to concept and process.

Figure 4.10
Comparing Incremental Budgeting with Zero-Based Budgeting

Zero-Based Budgeting	Incremental Budgeting
1. Evaluation of current activities and examination of alternatives leads to operational budget.	1. Operating budget is subject to series of incremental changes (increases or decreases) on a line-item basis, often with an overall budget increase set.
2. Ignores past behaviour and assumes a clean slate of activities.	2. Accepts the existing programs and estimates costs of new activities or changes, including decreases.
3. Creates cost/benefit analyses of all alternatives for all programs including the status quo.	3. Focuses analysis and alternatives on changes to programs and on new activities.
4. Focus is on the program architecture and need, which ensures the continuation of activities.	4. Focus is on costs and money, rather than program continuity, and generally assumes that existing programs will continue.
5. Examines new means of delivery for existing programs.	5. Budget process not used to re-evaluate existing programming.
6. Decision makers faced with options, alternatives and different levels of services decisions within the budget package.	6. Little scope for examining alternatives.

Source: Adapted from Jerome B. McKinney, Effective Financial Management in Public and Nonprofit Agencies, 3rd edition (Praeger, 2003).

A ZBB approach to budgeting can be very effective during a time of drastic reduction that requires the organization to undertake a thorough review of its programs in order to determine how to make fundamental adjustments. For instance, one federal government introduced a process called Strategic Reviews to address its need to reduce expenditures.[12] We will see in the discussion of reallocation and cutbacks in Chapter 7 that the inherent elements of ZBB can be useful, when applied on a selective and focused basis. What is key for any kind of base review to work is that:

- Nothing was held sacred.
- Assessment criteria are given.
- All programs were subject to initial or cyclical scrutiny.
- A formal governance process was created at the Cabinet level to ensure that decisions are made.
- Decisions were based on this process.

12. For information on the Strategic Review process, initiated in 2007 by the federal government, see https://www.tbs-sct.gc.ca/sr-es/index-eng.asp

Governments and other public-sector organizations have struggled with many forms of budgeting in order to get at the problem that ZBB was trying to address: how to deal with entrenched programming costs that had become virtually immutable. Where this form of budgeting floundered was in trying to do too much within the budgetary process itself. Where it shows continued applicability is in the current trend toward reallocation and program review type activities to be discussed in Chapter 7, **Shifting Priorities: Reallocation and Reduction**.

Performance or Results-Based Budgets

Performance or results-based budgets are intended to draw a link between the resources being dedicated and the results desired from the program. While a line-item budget is focused entirely on inputs and a zero-based budget goes back to basics and reinvents itself each year, the performance budget focuses on outcomes and results:

- Budgets are closely linked to the results, objectives, outputs or outcomes desired.
- The desired results – based on public policy decisions – would justify the budget levels.
- Performance measures, targets, and anticipated outcomes would be stated in the budgetary process.
- Results are reported in retrospect as a means of increasing this link between money and what it buys, and improving accountability.

Performance-based budgets have a number of essential elements.

- Services are defined and measures are created for them.
- Disaggregating services permits individual costing and the development of workload measurements.
- Service standards are developed.
- Costing methodology is standardized.
- Unlike other budget formats, they contain a narrative to explain service levels, the basis on which they are costed, and how costs are distributed.
- They involve some form of benchmarking, to provide comparative data for costs and workload levels in similar circumstance (e.g., comparing the cost of garbage collection between one town and another).

In a sense, a performance budget is a functional budget that defines both outputs and, to some degree, outcomes. It is a functional budget because most of the line items will be functions to be delivered – public safety in a municipality, counselling services of a family-service organization, etc. In addition, however, the performance budget is designed

to provide a clearer picture of what level of service is to be provided for how much money and with what results. An example of this would be adding to the Killaloe Hospital budget documents information that outlines some of the following outcomes:

- Number and types of operations
- Waiting times for operations
- Cost per operation, and
- Changes in service levels.

It could be argued that some of these items are not results. This is true. That is why the term performance also comes into play. Often results, let us say, a healthier population at reasonable costs, can prove elusive. Attribution can be contentious. Are more operations going to make people healthier? Is cost important or not? Therefore, in developing a linkage between budgets and results, often surrogates or approximate measures are used. The simple reality is that the desired results – a healthy population – has so many contributing factors that it cannot easily be linked to a budget without making some inherent assumptions about performance.

Often the link between budget data and performance outcomes is not entirely clear and may be difficult to define. For example, a performance budget could readily develop standardized costs for police patrols and show the cost of that activity. This would permit decision makers to see that adding more resources in this area would increase those patrols. There would be an assumption that these added patrols would reduce crime and increase public safety – which is the desired outcome – but even a performance budget could not stretch the linkage that far on its own. It would take other studies and data to establish that patrols actually reduce crime and that this increases public safety, a very amorphous outcome. Rather, the performance budget is a good step towards costing services, clearly identifying service levels of current resources, and helping decision makers make a better link between those two when determining future resources. A direct link to outcomes requires more information or built-in assumptions about policy outcome than even a performance budget can provide. **Figure 4.11** compares performance budgeting with traditional budgeting on a number of dimensions.

Figure 4.11
Traditional Budgeting and Performance Budgeting

	Traditional Budgeting	Performance Budgeting
Budget Orientation	Money control	Linking money to program and activities
Appropriation Control Level	Department	Program
Basic Budgeting Unit	Object, object code or line item	Activity
Efficiency Measurement	None	Unit cost, volumes
Result Measurement (Effectiveness/ Quality)	None	Program levels, activity levels
Budget Period	One year	Ongoing – year over year

A performance-budgeting approach takes considerable groundwork and time. In **Figure 4.12**, Jerome McKinney sets out the steps.

Figure 4.12
Seven Steps in the Development of a Performance Budget

1. Define individual work activities in terms that are measurable and can be related to resource requirements.
2. Inventory the work units and the kind of work that must be performed on each.
3. Develop quantity standards for each activity to permit an estimation of the amount of work required during the year, expressed in terms of annual number of units of work. Quantity standards are used to define the workload to be undertaken and the minimal acceptable quality of work necessary to carry out an activity.
4. Determine the number of work units per activity. This task is made easy after the quantity standards and inventory of the amount of work to be done on each activity have been established.
5. Establish production standards. The efficiency with which work is performed is a function of how the workers are assigned and equipped and the methods used in performing work activities. Responsibility should then be assigned to investigate and evaluate alternative methods for accomplishing each activity.
6. Compute resource requirements by applying production standards to the defined work program.
7. Collect cost data and convert the performance-budget resource requirements into financial terms.

Source: Jerome B. McKinney, *Effective Financial Management in Public and Nonprofit Agencies*, 3rd edition (Praeger, 2003).

Organizations find that the development of costing and workload measures often meets internal resistance. For example, there are very few child counsellors who believe that standardized costing for a counselling session has any meaning whatsoever. They are probably right. The organization has to struggle with measures that have both internal and external meaning. Such measurements may not even be possible or affordable. Often, the development of such measures entails so much work that the organization loses focus on its clients. The challenge for the organization is that it has to use the data it has to develop its budgets.

Similarly, the public or stakeholders involved with a performance budget have to be convinced that what is being costed is valid. This debate will involve a mix of discussions about both the validity of the metrics and the efficiency of the current service. Suppose an average 911 call is presently costed at $250 (mostly staff time) per call and the 911 unit is trying to build a case for more resources on a workload increase. To meet performance-budget criteria, it must

- show how it developed the original cost of $250 per call and defend that costing as the most efficient output it can produce for this amount of money, i.e., the effectiveness and efficiency criteria.
- show how demand has changed.
- demonstrate how the resources contribute to the timely emergency response capacity of the city.

Through performance budgeting, the 911 unit would subject itself to a degree of public scrutiny and debate before any decisions on resource increases could be made. If the agency has properly established its costs and services, this can be a powerful tool for arguing for the resources it believes it needs to deliver its service. Getting that understanding and consensus takes considerable effort, but it does serve a greater purpose in that the budget process is better informed.

Performance budgeting is similar to ZBB in that it can become mired in process. Perhaps the grandmother of large performance-budgeting systems was Planning, Programming, and Budgeting Systems (PPBS). This complex planning and budgeting process is often associated with Robert J. McNamara, who tried to introduce it into the American Department of Defense during the Vietnam War. Not only was it complex and demanding, but it also led to macabre measures such as body counts of those killed in the war. Such complex systems tend to consume valuable executive and managerial time in internal processes while ignoring the realities of the client base.

Even simple systems of performance budgeting may become too much for the organization to bear in terms of time and attention. Developing applicable costings and unit prices for specific activities demands both technical expertise and considerable bureaucratic clout to come up with measures that make sense for the program. This latter concern can lead to internal debate and conflict.

Notwithstanding the challenge that the use of performance-budgeting presents, it is a wise manager who has good measures of his or her activities, who can establish costs, and who can then use those costs and measures to advise on the implications of program changes. Without these, the manager is often left at the mercy of those who would assign their own measures or leave decision makers with the impression that the program is not using all its resources effectively and so could readily absorb a greater workload.

Governments around the world have adapted various forms of performance or results-based management, often with different names, but all with characteristics similar to what has been discussed above. For instance, in 2012, the Province of Alberta passed the ***Results-based Budgeting Act*** to require that all parts of the broader Alberta public sector budget in this way. This follows the adoption of a results-based budgeting approach in Ontario in 2003, making it an early adopter. At a more global level, the United Nations published its ***Results-based Programming, Management and Monitory (RBM) – Guiding Principles – UNESCO.***

Some Concluding Thoughts and What This Means to Managers

Budgets in the public sector are an important link between those who create public policy and those who implement it. They are, in fact, the principal means of putting those policies in place and assigning the required resources to implement them. By law, they create both a limit on expenditures for the manager and the authority to spend the resources.

Budgets play an important role in the management of public-sector organizations. While they can be organized in a number of different ways, they always serve as valuable instruments of public policy. The structure of a budget will generally reflect the complexity of the organization itself. Managers, however, have to navigate among a variety of objectives in order to fully understand the budgetary process (getting the resources), the allocative and reallocative processes inherent, and the accountabilities built into those budgets. We will be exploring these topics in the next two chapters of this section.

The key to holding managers responsible for results is to ensure that they have the resources they need to do the job. They must also have them in a timely fashion, i.e., when they need them. As we will see when we examine the budgetary process, there are timing problems in Canadian governments, especially when it comes to intergovernmental transfers and transfer payments from funding provinces to hospitals and schools.

The budget of a unit or section of a government department further disaggregates the larger departmental budget, assigning resources in a specific way to that unit to carry out its work. It is a fundamental reality that managers must manage their performance targets, not only with the resources they are directly assigned in the budgets (think of their set of line items for staff, supplies, etc.), but also with those resources held centrally for functions that serve all the organization. As a simple example, think here of the dependence of a line manager on computer support provided by another part of the organization. Therefore, it behooves a manager to understand not only her budget and plans, but those of the many parts of the organization upon which she depends to get the job done.

As the next chapter discusses, the planning and budgeting process involves setting goals and expectations about activities to be undertaken with the resources allotted. The assigned budget of a responsibility manager is also a benchmark against which to measure that manager's performance, especially in areas of program and financial control and attention to public funds.

Appendix 1, ***The Budget Games People Play***, gives a sense of the budget as a bureaucratic battlefield. Like any other field of engagement, it invites the use of strategies and tactics so that managers can maximize the benefits for their programs. It is about winning and losing, as resources are scarce. Further, resources equal power and influence as well as a means to get something done. Maximizing resources means having the influence that many seek in organizations.

Chapter 5
The Planning Process and Budget Cycle

Chapter Objectives:

- Linking the budget to the planning process of organizations
- Examining simple and complex budget cycles
- Appreciating the dynamic nature of budget decisions
- Relating issues of revenue and cost to budget outcomes
- Examining fundamental tensions in public-sector budgeting

Introduction

Budgets do not just happen. They are the result of extended planning and policy-setting processes, involving both top level strategic direction and its translation into actual resources being spent on actual programs, often bringing program managers into the picture to make those lofty strategic goals a reality. The budgetary planning and design processes lie at the heart of achieving these objectives. Learning both the art and the science of budgeting is essential to good financial management in the public sector. Similarly, understanding how the budget-formulation process works within an organization allows the manager seeking funds for program purposes to influence the outcomes to the advantage of that program.

The public also has a strong interest in influencing budgetary outcomes. After all, it is only when funds are allocated that policy outcomes and strategic goals become real. The public, be it the general public, special interest groups or lobbyists, has an interest in knowing what is going on. Budget-formation processes have become more transparent and participatory, as the public and interest groups have demanded more engagement before decisions are made. For example, most provincial and federal governments have, in the past, treated the budget as a top-secret document. If any portion were leaked in advance, the finance minister's resignation would be sought. Today, most governments engage in some form of structured pre-budget consultation process both within their legislatures and directly with interest groups. We see an increase in strategic budget leaks, often made to test out an idea.

Municipal governments in particular are very open in their budget processes, engaging citizens very early in decision making so that there is very little surprise when the budget is formally presented. One other important feature of municipal budgeting is that the initial budget draft is seldom the end of the budget process, but rather the beginning. Unlike at provincial and federal levels where the budget is a matter of government policy and subject to a confidence vote, in our towns and cities, the draft budget goes through a very open process of give and take with many alterations along the way before there is a final budget that the Council approves. Increasingly, within public-sector organizations, most of the budget is known in advance – the results of good planning and an adequate level of stakeholder involvement, as well as a recognition of the new world of intense lobbying, complex communications, and technological capacity to move information around.

The budget process is an important management tool, not just for assigning scarce resources, but for purposes of planning, setting direction, internal control and accountability. As we see in so many aspects of financial management in the public sector, not much happens until the money is in place to make it happen. Further, the resources of public-sector organizations are subject to

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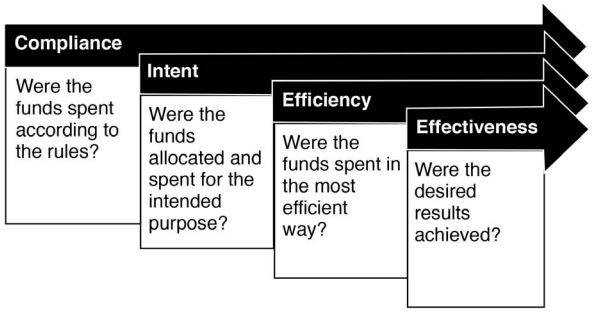
so many controls and scrutiny for the simple reason that they *are* public funds. Effective management of them is a first step of accountability for public-sector managers. Moreover, in the absence of good measures of outcomes or output performance, the budget often serves as a means of measuring performance. Even as governments improve their performance measures as we will see in **Section 4: Reporting & Measuring Performance**, everyone still watches the money. They have a number of concerns that start to move us, as we will throughout this text, along the continuum of accountability. This gradation in accountability associated with the budget is shown graphically in **Figure 5.1**.

Figure 5.1
Budgetary Accountabilities


Compliance
Were the funds spent according to the rules?
Intent
Were the funds allocated and spent for the intended purpose?
Efficiency
Were the funds spent in the most efficient way?
Effectiveness
Were the desired results achieved?

This chapter looks at how strategic planning informs budgeting and priority setting. It also examines how budgets are created through a budget cycle. It examines how costs are determined and the many variables that come into play in budget design. It opens a discussion on the issue of budgetary sustainability, ensuring that budget decisions can be carried out effectively over time. Finally, it looks at some new issues relevant to the budgets process such as gender-based budgets. In all this, we will move from the high-level government or departmental budget to the budget of the individual program or unit. This chapter is intended to show the relationship between the two. Because of its unique character, capital budgeting is addressed separately in **Chapter 6**, **Capital Budget – The Infrastructure to Deliver. Chapter 9, Shifting Priorities: Budget Reduction and Reallocation**, looks at how managers often must reverse the process and reduce resources or find other means to fund programs.

While budgeting is often just about getting the money, it is also about power, or influence, and holding one's own in a complex organizational environment with many competing internal and external forces. Hence, **Appendix 1**, **The Budget Games People Play,** presents just some of the dynamics that can come into play as individuals engage in defending turf, trying to get more or to change the budget.

The budgetary process is central to how public-sector organizations operate, and how they are seen by the public. In 1986, Aaron Wildavsky wrote:

> The allocation of resources necessarily reflects the distribution of power. Budgeting is so basic it must reveal the norms by which men live in a particular political culture; it is through the choices inherent in limited resources that consensus is established and conflict is generated. The authority of government is made manifest by its ability to not only make a budget but also to make it stick. Public policymaking decides what programs will be enacted, who will benefit from them, and at what monetary levels they will be supported. Public policymaking is epitomized through the budget. So is implementation, for when push comes to shove, programs will not be carried out as intended (or at all) unless commitment is memorialized by money. If justice delayed is justice denied, then a budget rejected is a program aborted and a fund diverted is a policy perverted. When a process involves power, authority, culture, consensus, and conflict, it captures a great deal of national political life.[1]

Budgets and Planning Cycles

Most governments, departments, or units of organizations establish formalized processes to produce their final budgets. Within operational units, arriving at the final distribution of the operating budget will entail some measure of forecasting, analyzing of options, setting plans in place over the long term, and finally, assigning resource levels. This is the budget cycle.

1. Aaron Wildavsky, *Budgeting: A Comparative Theory of Budgetary Process,* 2nd edition (Transaction Books, 1986).

Figure 5.2
Working Definition of a Budget Process

A good budget process is far more than the preparation of a legal document that appropriates funds for a series of line items. Good budgeting is a broadly defined process that has political, managerial, planning, communication, and financial dimensions. The following definition recognizes the broad scope of the budget process and provides a base for improvement of the budget process.

The budget process consists of activities that encompass the development, implementation, and evaluation of a plan for the provision of services and capital assets.

A good budget process is characterized by several essential features. A good budget process:

- Incorporates a long-term perspective
- Establishes linkages to broad organizational goals
- Focuses budget decisions on results and outcomes
- Involves and promotes effective communication with stakeholders
- Provides incentives to government management and employees.

These key characteristics of good budgeting make clear that the budget process is not simply an exercise in balancing revenues and expenditures one year at a time, but is strategic in nature, encompassing a multi-year financial and operating plan that allocates resources on the basis of identified goals. A good budget process moves beyond the traditional concept of line item ex¬penditure control, providing incentives and flexibility to managers that can lead to improved program efficiency and effectiveness.

Source: Government Financial Officers Association: "Recommended Budget Practices." See http://www.gfoa.org/services/nacslb/

The Budget Cycle: The Basics

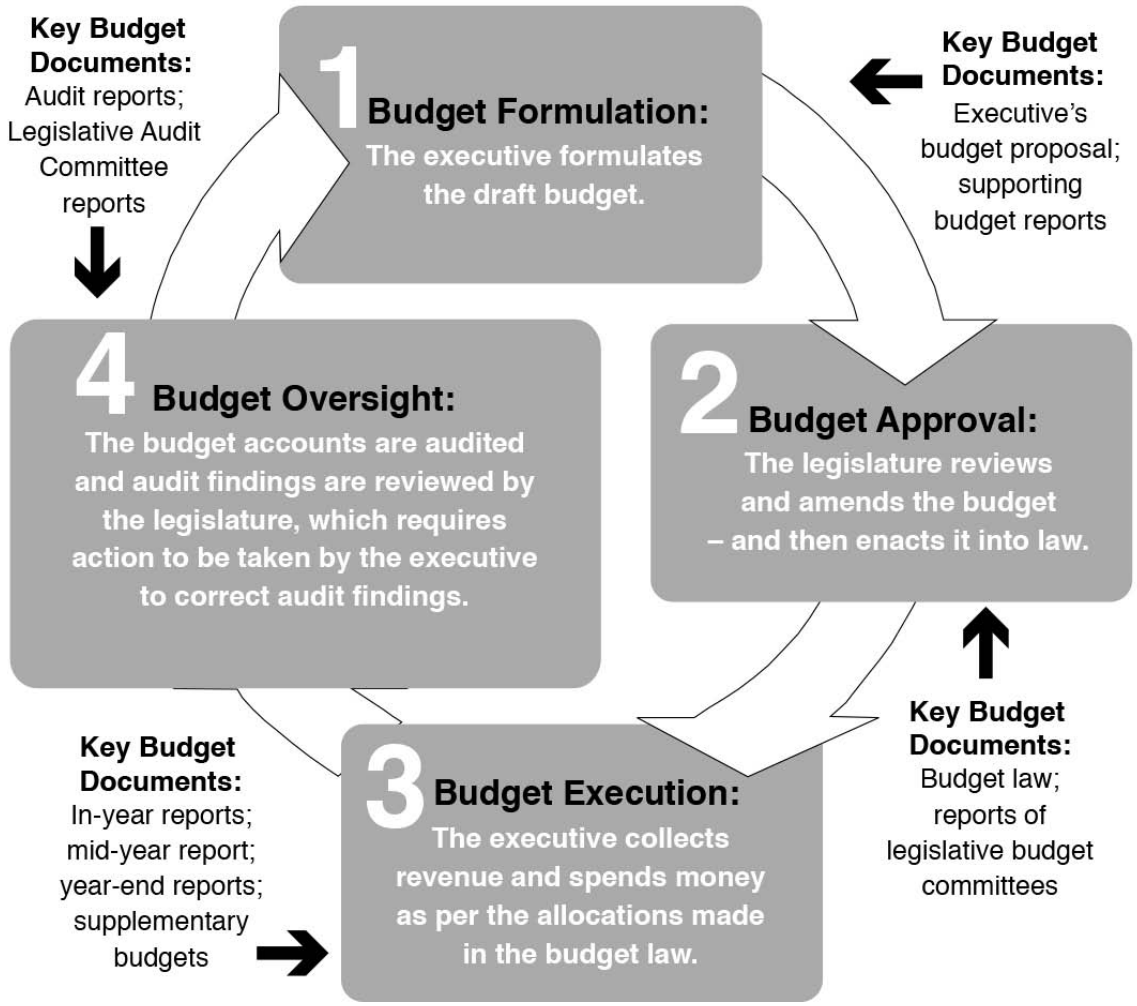
Budget cycles, planning systems, and procedures are tools of public-sector management. You can give them any name, e.g., strategic-planning systems, planning, budgeting systems, etc.; you can flow-chart them, PowerPoint them, and build in all the bells and whistles that the organization needs, wants, and likes. Regardless of how they are presented, some basic requirements have to be met, regardless of the size or complexity of the public-sector organization. Organizations will have the following characteristics.

- **Basic framework** has common language, meaning, and reference points for all players in the process to use.
- **Desired outcomes** are approved by the government or agency's leadership.
- **Linkage to mission, vison and the strategic plans** of the organization, especially with respect to increases or reductions in program levels, investments in new programs, and the multi-year implications of the plan are evident.
- **Format used by all units** of the organization will ultimately roll up into the organization's spending plan for the coming period as defined (usually one year).
- **Timetable** for preparation and consideration of budgets within the organization is established.
- **Technical directions** define the objectives of the current process and whatever budgetary and program limits the organization chooses to set in advance, including expenditure limits and instructions on matters that are handled at the corporate level of the organization and not to be addressed in the units (such as collective agreements that are organization-wide), and their implications for salaries and benefits.
- **Methodologies for costing and forecasting** current program levels include the implications of changes in service demands or standards, and the cost of new initiatives.
- **Targets** which the unit manager must seek to reallocate current funding, absorb known cost increases, or access additional funds.

Real-life processes are less clear and often less logical than described above, but in trying to outline an effective budgetary process for a public-sector organization, it is necessary to establish standard expectations against which it might be judged. Managers trying to operate in whatever budget process exists in their organization should look for these features and, in their absence, attempt to make them happen. Generally, the budget process is managed by a central finance office. If it is effective, it will be trying to make the above happen.

The Simple Budget Cycle shown in **Figure 5.3** is a good starting point for understanding the budgetary process. It is at a very high level and accurate way of thinking about how budgets are formulated and executed.

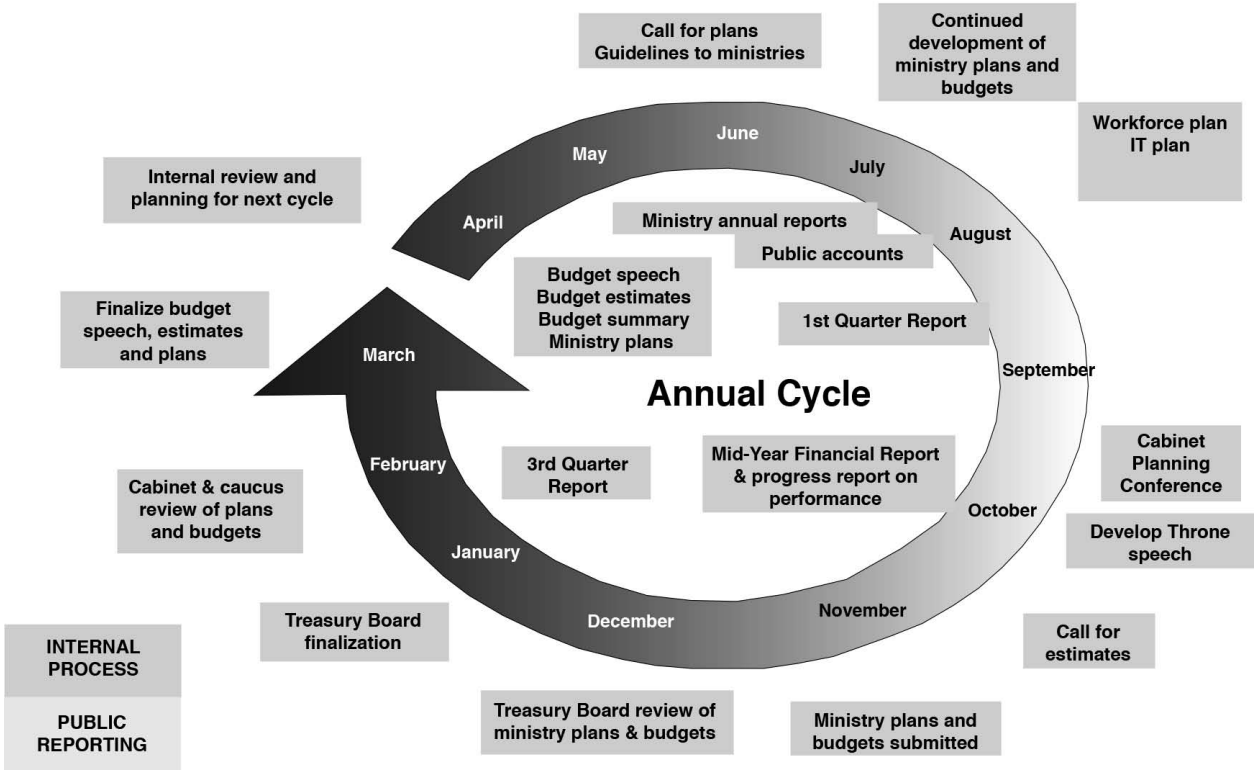
Figure 5.3
A Simple Budget Cycle


Key Budget Documents: Audit reports; Legislative Audit Committee reports
1 Budget Formulation: The executive formulates the draft budget.
Key Budget Documents: Executive's budget proposal; supporting budget reports
2 Budget Approval: The legislature reviews and amends the budget – and then enacts it into law.
Key Budget Documents: Budget law; reports of legislative budget committees
3 Budget Execution: The executive collects revenue and spends money as per the allocations made in the budget law.
Key Budget Documents: In-year reports; mid-year report; year-end reports; supplementary budgets
4 Budget Oversight: The budget accounts are audited and audit findings are reviewed by the legislature, which requires action to be taken by the executive to correct audit findings.

Source: These materials were developed by the International Budget Partnership. The IBP has given us permission to use the materials solely for noncommercial, educational purposes. See http://internationalbudget.org/getting-started/why-are-budgets-important/

The logic of diagrams such as this can be deceiving because the reality of budgeting will not follow the steps of this cycle so precisely. Recall the section in the previous chapter on the multi-level and multi-year elements of the budgetary process. As outlined in **Figure 4.2**, there are three timeframes to budgeting: past performance, present budget, and future spending plans. While one budget is being implemented, the next one is being planned. As one approval phase ends, the review of results of the previous year may begin. This sequencing is not linear. Rather, it is multi-dimensional. Separating them out for discussion is necessary, but somewhat misleading as the process, even as it marches through the centrally ordained steps, remains a messy one. **Figure 5.4, Saskatchewan's Planning and Budgeting Cycle,** is a good illustration of the kind of complexity that is the reality of the budgetary process.

Figure 5.4
Saskatchewan's Planning and Budgeting Cycle



Source: http://www.finance.gov.sk.ca/PlanningAndReporting/GovernmentPlanningAndBudgetingCycle.pdf

Strategic Planning Phase

All organizations plan for the future. Making choices about programs and priorities sets a direction, communicates values, distributes resources and establishes accountabilities. Some organizations have complex and well-documented planning processes, such as the Saskatchewan model. These can involve many levels of the organization, often working together in the preparation of documents and the provision of information. For others, planning and budgeting are much simpler because the lines of control and command are shorter and the decision making is more immediate.

The planning and budgeting process of the Government of Saskatchewan as shown in **Figure 5.4** is a good example of a complex budget-planning system. It is designed to ensure that the final budget of the minister of finance is the result of a rigorous planning process.

This process takes into account the relationship of the political leadership – Cabinet and the premier or prime minister with bureaucratic leadership through the Treasury Board, which provides the advice and support needed for decision making. This is both a strategic-planning and a budgetary process.

Strategic planning includes more than just budgeting, drawing on the many tools of planning beyond simply resource allocation and distribution. At least, that is the theory: that strategic planning should be driven by values and outcomes and that issues of financing the vision should be left to the next iterative phase of planning. The reality is somewhat different. Of course, strategic planning should be long-term and visionary, but based on a realistic assessment of circumstances. Financial information about the past and present naturally feeds thinking about the future, and anticipated revenue flows to public-sector organizations will temper multi-year projections. Governments have to take into account their informed view of revenue growth, economic projections, policy aspirations or debt and deficit reduction goals. Otherwise, the political leadership would be accused of creating false expectations. Thus, the strategic-planning process must be conscious of financial realities. Some characteristics of strategic

planning differ from the annual budget-preparation phase. For instance, most strategic goals are future oriented, well beyond the one-year approval and three-year time horizon of most budgets.

Strategic planning is generally program-oriented. It involves the creation of a hierarchy of strategic tools that permit the organization, in an ideal world, to guide decision making and set priorities for the organization as a whole. It is also important in the establishment of desired end states – say, a certain level of environmental emissions to reduce pollution – as a means of measuring the outputs desired for the organization. As such, most strategic planning is mission- or goal-driven, using long-term and broadly based objectives.

The Architecture of a Strategic Plan

Strategic plans usually contain a basic set of components that describe the purpose of the organization and its intended direction over a prescribed period, as discussed above. While they may take many formats, they have common elements most notably:

- **Mission** is a comprehensive statement expressing the purpose of the organization.
- **Vision** is a statement of the ideal state or end-results pursued by the organization.
- **Guiding principles** are the philosophy that steers the organization in delivering services and accomplishing its mission. Another phrase used here is **Values**.
- **Situation analysis** is a description of key internal and external trends that are likely to affect the agency over the time period of the plan. This is also called an **environmental scan.** This has to take into account elements such as financial conditions, both internal and external; clients' needs and issues; technology; organizational overlaps; changes to demand levels; character of the clientele; and new issues.
- **Goals** are statements that describe the agency's destination, direction, and intent for the period of the plan.
- **Objectives** are initiatives that implement the goals; that is, precise statements of the desired results of completing a series of action steps.
- **Performance measures and targets** are precise milestones for each objective that will help the organization evaluate progress toward its objectives and the goals that it supports.
- **Linkage of general goals to annual performance plan** is a description of the relationship between annual goals in the performance plan and the general multi-year goals and objectives in the strategic plan.
- **Resources needed** describe the human, capital, information, and other resources, as well as the operational processes, skills, and technology needed to achieve the agency's goals, which highlight where significant change from currently available resources will be needed. Note that this is not the budget for the coming year, but a resource discussion that will certainly affect budget decisions in future years.
- **Program evaluation** is a description of how the results of programs or policy will be evaluated.

The translation of the goals of strategic planning into results is often a difficult one. A balance must be struck between investing too many resources and too much time in the strategic phase and not enough in the actual implementation phase. Getting the framework right is important, in terms both of getting the right work done but also in convincing stakeholders that the organization deserves support – be that from tax dollars, fees, or contributions – to carry out its role. The Strategic Plan of the City of Halifax is a good example both of a structure that generally follows this format and the high-level nature of such plans. It is shown in **Figure 5.5** on the next page**.**

Moving to Action and Into the Budget

The strategic-planning process of the Government of Alberta is designed to guide budget building and to link various departments by means of what are termed cross-government priorities to ensure that the strategic element of the planning is retained. It is outlined in **Figure 5.6.** A cross-government priority is one that involves several government departments in achieving an over-arching objective. Public policy issues seldom align themselves along neat organizational lines. In fact, it is an attribute of twenty-first century public administration that public policy challenges are complex, multi-dimensional and, increasingly, wicked, i.e., a challenge that is not resolved easily in a short period without complex responses.[2] Therefore, a department needs to understand its role in resolving cross-governmental issues.

The strategic-planning format that a public-sector organization develops will suit its needs. Having it well documented and using it in a consistent fashion will ensure greater stability in budget outcomes for the organization.

2. A good source of background on the concept of wicked problems is available in a publication of the Australian Public Service Commission, *Tackling Wicked Problems*. See http://www.apsc.gov.au/__data/assets/pdf_file/0005/6386/wicked-problems.pdf

Figure 5.5
Strategic Plan of the City of Halifax, 2017–21

Strategic Plan 2017 - 21
VISION
HRM's vision for the future is to enhance our quality of life by fostering the growth of healthy and vibrant communities, a strong and diverse economy, and sustainable environment.
MISSION
We take pride in providing high-quality public service to benefit our citizens.
We make a difference.
VALUES
• Respect • Collaboration
• Diversity & Inclusion • Integrity
• Accountability • Sustainability
• Evidence-Based Decision Making
COUNCIL PRIORITY AREAS
ECONOMIC DEVELOPMENT
HRM is a sought after business destination that encourages entrepreneurial spirit and is responsive to the needs of the business community.
SERVICE DELIVERY
HRM meets the needs of the people it serves, resulting in greater satisfaction with, and confidence in the municipality.
HEALTHY, LIVEABLE COMMUNITIES
HRM is a safe, livable and sustainable community that encourages public engagement and participation in civic life.
SOCIAL DEVELOPMENT
HRM's communities have access to social infrastructure that supports all segments of the community.
GOVERNANCE & ENGAGEMENT
HRM's governance structures and communications approach provide maximum opportunity for public engagement in and enables appropriate stewardship of municipal affairs.
TRANSPORTATION
Integrated, multi-modal, long range plan to move people and goods in HRM in support of neighbourhoods, communities & economic growth.
COUNCIL PRIORITY OUTCOMES
ECONOMIC DEVELOPMENT
ATTRACT & RETAIN TALENT
HRM is a welcoming community where the world's talent can find great opportunities.
PROMOTE & MAXIMIZE GROWTH
HRM promotes a business climate that drives and sustains growth by improving competitiveness, minimizing barriers and leveraging our strengths.
RURAL ECONOMIC DEVELOPMENT
The economic viability of rural communities is included as an integral aim of regional economic growth strategies and their implementation.
FOCUS ON THE REGIONAL CENTRE
HRM has a vibrant, animated and economically healthy Regional Centre that is a cultural, business and education hub with a growing population.
SUPPLY OF INDUSTRIAL, COMMERCIAL & INSTITUTIONAL LANDS
Ensure that there are sufficient industrial, commercial and institutional lands available to provide economic opportunities.
MAKE HALIFAX A BETTER PLACE TO LIVE AND WORK
Recognize and support heritage, cultural activities, and arts to bolster the creative economy and the vitality of the region.
SERVICE DELIVERY
SERVICE TO OUR BUSINESS
HRM simplifies processes and delivers service to promote and encourage a vibrant business environment.
SERVICE TO OUR PEOPLE
HRM understands the needs and perspectives of the people they serve, and provides quality service through a person focused approach.
INNOVATION
HRM will foster a corporate culture that values innovation and bold ideas and supports the rapid deployment of experimental pilot projects and civic innovation project teams.
HEALTHY, LIVEABLE COMMUNITIES
PUBLIC SAFETY
HRM citizens and visitors are safe where they live, work, and play.
ENERGY & ENVIRONMENT
HRM builds resiliency by providing leadership in energy management, sustainability and environmental risk management both as an organization and in the community we serve.
RECREATION & LEISURE
HRM citizens have access to facilities and natural assets that enable a range of choices for structured and unstructured leisure and recreation activities.
COMMUNITY HEALTH
HRM shall be an active partner in supporting community health program such as food security initiatives.
SOCIAL DEVELOPMENT
SOCIAL INFRASTRUCTURE
HRM communities, families, youth and seniors have access to social infrastructure that enables them to participate fully in their community.
ACCESSIBLE COMMUNITY
HRM is a leader in building an accessible community where everyone can participate fully in life, including persons with disabilities and seniors.
HOUSING & NEIGHBOURHOOD
HRM is a leader in fostering partnerships that provide access to a full range of quality, affordable housing options in safe and vibrant neighborhoods.
EQUITY & INCLUSION
HRM is a diverse and inclusive community that supports everybody.
GOVERNANCE & ENGAGEMENT
MUNICIPAL GOVERNANCE
HRM citizens have confidence in the governance structures of the municipality.
COMMUNICATIONS
HRM citizens and communities participate in open and transparent communication with the municipality.
PUBLIC ENGAGEMENT
HRM citizens and communities are engaged in the development of public policy and plans.
FISCAL RESPONSIBILITY
HRM manages municipal resources with integrity and considers the impact on taxpayers when making decisions.
TRANSPORTATION
INTERCONNECTED & STRATEGIC GROWTH
HRM will implement an integrated mobility strategy that supports growth, development and the transportation of goods and people of all ages and abilities, using all modes including walking, cycling, transit, and motor vehicles, consistent with the Regional Plan.
A WELL MAINTAINED TRANSPORTATION NETWORK
The Halifax Transportation Network is comprised of well-maintained assets.
A SAFE & ACCESSIBLE TRANSPORTATION NETWORK
The Halifax Transportation Network is designed to be operated to be safe, accessible and supportive of enhanced user experience and focused on service improvements.
PEDESTRIAN SAFETY
Drivers, cyclists and pedestrians all-share responsibility for travelling safely together. Through education, enforcement, and improved infrastructure (engineering), engagement and evaluation, pedestrians in Halifax are provided with a safe environment in which to walk.
HALIFAX

Figure 5.6
Strategic Plan of the Government of Alberta

The Government of Alberta Strategic Business Plan
Alberta's Vision: Today's Advantage, Tomorrow's Promise: Alberta's Vision for the Future

20-Year Strategic Plan: Today's Opportunities, Tomorrow's Promise: A Strategic Plan for the Government of Alberta

Medium-Term Strategies: Cross-Ministry Initiatives and Medium-Term Strategic Plans

3-Year Business Plan: 2004–07 Government of Alberta Business Plan.

The Government of Alberta Strategic Business Plan consists of the following:

Alberta's Vision for the Future which lays out Alberta's vision of "A vibrant and prosperous province where Albertans enjoy a superior quality of life and are confident about the future for themselves and their children."

It outlines the values that Albertans hold and identifies four key opportunities or "pillars" that will be used to realize Alberta's vision: unleashing innovation, leading in learning, competing in a global marketplace, and making Alberta the best place to live, work and visit.

A **Strategic Plan for the Government of Alberta** which is a 20-year strategic plan that flows from the vision document, Today's Advantage, Tomorrow's Promise: Alberta's Vision for the Future. The 20-year plan sketches a picture of Alberta in the year 2025 and contains broad strategies for achieving the four key opportunities outlined in the vision document.

The 20-year strategic plan is based on what the government has heard from Albertans in different forums over the last few years. It provides strategic direction for government planning and policies.

Cross-Ministry Initiatives and Medium-Term Strategic Plans. The Cross-Ministry Initiatives section sets out the objectives and targets for four policy initiatives that bring together various ministries to address corporate government-wide issues. This approach recognizes that many issues are not isolated to a single ministry. The 2004–07 policy initiatives are the Aboriginal Policy Initiative, the Alberta Children and Youth Initiative, the Economic Development Strategy, and the Health Sustainability Initiative.

The Medium-Term Strategic Plans section provides information on government strategies to address priority issues over a longer period of time.

The **2004–07 Government Business Plan** is an ongoing three-year plan linked to the fiscal plan and aligned with the broader strategies in the 20-year plan. The government business plan is published annually. It lays out the government's goals, strategies, and performance measures to track progress towards goal achievement.

Ministry business plans are also published annually and cover a three-year period. These ministry business plans are required to indicate how they link to the government business plan.

Source: http://www.finance.gov.ab.ca/publications/budget/budget2004/govbp.html#7

Budget Preparation Phase: Setting Direction, Getting a Say

In most cases, budget preparation involves two processes, of which the strategic-planning process is the first. The strategic plan will provide a set of program objectives, overall goals, and proposals for change. Just to complete the picture, let's call this the "wants" of the organization, i.e., its all-out vision.

The second process involves determining what resources a government actually has to meet its many requirements. What are the restraints? What are the limits? In short, faced with an endless array of wants, this is what contains the spending to what is possible or the "won't" part of the equation. This is where choices have to be made, and where trade-offs and reallocations come into the equation.

This process will involve direction from the government's central office on budget limits and specific conditions that apply to how individual program managers will design their budgets. Such instructions are known in various forms as the fiscal framework of the government. These are budget guidelines that senior management will issue to all responsibility centres to direct the preparation of their budget plans. Such guidelines will normally contain direction on the technical aspects of budget calculations and may establish spending limits in some or all areas and provide direction on how to incorporate changes – either up or down – in program plans and expectations. Such guidelines would also enforce standardized costing across the government. For instance, the City of Ottawa has created a budgeting fiscal framework, with the following elements:

- Asset management – protection and replacement of city's assets
- Growth and development assumptions
- Strategic initiatives and enhancements – linking to the Strategic Plan
- Debt – setting limits
- Operating surplus/deficit – setting policies such as no deficits
- Budgeting – outlining process
- User fees and service charges – principles and targets
- Property taxation – basis of calculation, target
- Program review – reviewing existing spending.[3]

These guidelines will vary in their breadth and scope. For instance, where collective bargaining is centrally managed, managers will simply be informed of salary increases

3. City of Ottawa, Fiscal Framework. See https://www.google.com/search?q=define+fiscal+framework&ie=utf-8&oe=utf-8&client=firefox-b

based on calculations by their staff complements. In some instances, managers may be instructed to absorb additional costs or negotiate them themselves. This can translate into a staff reduction if costs of collective agreements rise and no new funding is provided. It may also mean that managers have varying degrees of flexibility on staffing questions if their staff is formula- or workload-driven, as is often the case in large-scale operational departments.

Once the budget-preparation phase is reached and the framework set, there is usually limited room for flexibility. A rigorous strategic-planning exercise is about setting priorities that will reduce the scope for budget negotiations. So, too, will pressures to contain or reduce spending or to limit staff complements. This first phase is typically top-down, usually as part of the organization's planning cycle, under the oversight of a central office, reflecting the directions that the organization's top managers wish to take.

So where does the individual manager fit into this organizational behemoth? Perhaps it would be appropriate to say that the manager is really the third element, one possibly characterized in this tension of want and won't and the maybe. This element of the budget preparation is the influence of the manager who will be controlling the budget through its execution. As noted, the larger and more directive the organization, the less likely that there would be much flexibility in negotiating budget changes in this phase. Some variables and flexibility may still be in the hands of the manager. One example is the calculation or estimation of workload and costs to be used as part of the budget and planning. Another example is the role of the manager in proposing program changes and improvements. In all, this element deals with bottom-up proposals, not just for more money, but for changes to process, efficiency gains, or policy tweaks to reduce or transfer costs. This element of managerial influence suggests that budget preparation can also have bottom-up influences. In fact, any sensible budget process will have a good combination of top-down and bottom-up elements. See **Figure 5.7, Comparing Top-Down and Bottom-Up Budgeting.** Strong managerial analysis of increased costs or new proposals can sometimes affect the budget-preparation process and financing levels. Timing is everything, however, and managers must understand how to influence these processes. If they wait too long, boundaries will have been set and the organization will have little or no appetite for new funding ideas, especially in the near term.

Figure 5.7
Comparing Top-Down and Bottom-Up Budgeting

Top-Down Budgeting	Bottom-Up Budgeting
Definition Top-down budgeting starts at the highest level of the organization and works downwards. The central office determines funding levels and priorities. It assigns costing formula and growth assumptions. It directs the whole process.	**Definition** The budget process starts at the lowest level of the organization and aggregates upwards. Budget proposals are formulated based in individual programs and then aggregated. They are presented to top management for approval.
Characterized by: • Centralized direction • Global perspective • Focus on program strategy and prioritization • Fiscal constraints • Tendency towards common costing	**Characterized by:** • Unit-specific view • Client or program end • Exceptionalism • Growth oriented
Advantages: • Efficient • Strategically consistent • Saves time • Avoids incorrect costing assumptions • Enforces budgetary discipline • Fits to global goals • Directive – organizations need direction	**Advantages**: • Fits budget to program goals • Participative – managers need a voice • Reflects program's unique costs • Permits adaptation by those closest to client • Increases budget ownership
Disadvantages: • Creates one size fits all • Tends to treat all budget needs the same • Not program sensitive	**Disadvantages**: • Encourages budget increase proliferation • Potentially time consuming • Increases often unrealistic demands • Budget not in line with strategy

The bottom line of whether budget should be top-down or bottom-up is that it depends on the government and what it wants to achieve. Clearly, where governments want to induce greater fiscal discipline, redirect overall strategy and see budgets reallocated to new priorities, there is little use of much bottom-up budgeting until the rules are well laid out. Where the budgetary situation is more flexible and the government wants to think through growth and change ideas, it may be more fulsome in seeking proposals.

The reality is almost all cases is that the budget process tends to be bit of both. It is a waste of a manager's time to engage in work calculating possible salary increases in her budget if salaries are set centrally, either through collective bargaining or by central office. The manager just wants

to know what the projected salary costs are and whether she will get money for any increases. After that she can make all kinds of proposals. The central offices, either of the department or government will want to know about cost, volume and program enhancement pressures. They will need this from the program manager. The process therefore is quite iterative.

Workload Forecasts in Budget Calculation

Unless a new program is being implemented, workload determinants will be based on historical data. Of course, changes in assumptions are possible, and they are often taken into account in the planning process. Managers have to make predictions about anticipated workloads that will form the basis of the budget. Historical-trend data make an easily available and useful tool. The challenge is that even this historical information is open to interpretation. In many instances, a central budget or planning office may see things differently from the line manager. Getting agreement on data, assumptions, and predictions is an important part of budget calculations. One reason that it can be difficult to reach an agreement on the meaning of workload information is that it is both historical and speculative. For instance, the central budget planner (or even the manager himself), may see workload costs this way:

- This reflects inefficient work practices in this program and costs can be reduced through efficiencies.
- What is the basis for assuming things will be the same next year or even grow?
- These projections suffer from availability bias, i.e., you are measuring the readily available information.

For the budget advocate or program manager, the workload data might be seen this way:

- Budget is not keeping up with increased demand.
- We are suffering various forms of mission creep with the addition of minor changes that increase our costs or the emergence of new technologies that drive up our costs.
- If we are going to reduce workload costs, we have to invest in new technologies, so we need more money.

That being said, workload and demand projections are an important part of both the strategic and budget planning process, especially if the present set of assumptions is shifting in a program.

The following are some cost and volume measures and how they can affect such judgements on workload levels and cost:

- **Need measures:** This is a highly elastic measure that can be the result of applying policy-driven definitions like those found in entitlement legislation, or a pattern of requests that the organization has met in the past or, more debatably, a pattern of unmet needs perceived by the management of the program. While need is often in the eye of the beholder, there are other significant determinants of need. For instance, benchmarks can often identify needs. In terms of how much maintenance is needed to keep public infrastructure safe, many such benchmarks exist.
- **Demand measures:** Here again, both objectivity and subjectivity come into play. Some can be highly credible measures of demand. For example, a neighbourhood with a certain pattern of break-ins over a number of years has a demand for police services on a more regular basis. The police service would be challenged to increase its presence in the neighbourhood, do outreach programs to households to increase safety measures and monitor patterns.
- **Workload measures:** These should be seen as operational indicators involving units of service to the public. In the example of the incidence of break-ins in one neighbourhood, workload data can be based on the cost of a police call-out and investigation. While these workload measures are generally non-financial in nature, combining the results of such measures with costs will generally drive a budgetary process. The disadvantage of such measures is that, being historical, they do not reflect any changes for the future, nor do they necessarily demonstrate the most effective means to achieve the end. The workload data alone cannot provide this information. It may be that less expensive forms of intervention, such as preventive patrols and foot checks of vulnerable buildings, could reduce overall costs and be more effective than current call-out measures. These would be known as process improvements, preventive measures, or alternative delivery options that reduce the impact of the more retrospective workload measure.
- **Productivity measures:** Often, in the budget formulation, the relationship between costs and outputs will be taken into account to arrive at a per-unit cost. The organization may then seek ways to reduce them. For instance, senior management may direct that budgets be prepared with increases in productivity built in, in which case, workload measures are assumed to be altered a priori, on the assumption that it is possible to reduce costs through process or managerial improvements. Historical data at an eldercare facility may suggest that overtime funds to cover sick and

vacation leave would be 12 percent of the total salary budget as has been the case in the past four years. However, senior managers, feeling the pressure of such costs, may ask for improvements to duty rosters, reduction in some nursing stations, and closer leave-management programs to reduce the budget to 6 percent of overall salary dollars.

- **Per unit costs:** Standardized costing of procedures is common in organizations that engage in repetitive activities. Such methodology is pervasive and generally useful as long as it is applied with some connection to the real world and with some recognition that there can be significant variation. For instance, it is possible to apply a standardized cost to a paramedic intervention in a particular community. It then become possible to look at that cost among different communities as long as issues such as distance and traffic congestion are factored into variances that may occur.

Cost Analysis and Forecasting

The costing process in budget formation has both upward and downward dimensions. In the determination of the cost of a particular activity or service, many other organizational issues come into play. The larger and more complex the public-sector organization, the greater will be the tendency for the central budget office to try to assign unit costs for cost-control purposes and to establish uniformity within the organization. From the other end, managers will want to ensure that costing formulae accurately reflect their view of the true cost of the program and that their flexibility is not necessarily limited by the costing formulae. Similarly, in smaller public-sector entities, the board or council will want to contain costs, whereas the providers will have a tendency to expand them, especially when those entities offer open-ended services for which demand is hard to limit. Such tensions will play themselves out in any so-called objective process of cost determination. Further, it may take a considerable time for an organization to fully understand or fully agree to the costs of particular programs and services. Finally, and perhaps most contentiously, the distribution of costs to various budget managers in complex organizations becomes a matter of great debate. The following statement for the United Kingdom Chartered Institute of Public Finance and Accountancy, sets out the situation nicely:

> As the public services become more competitive and the emphasis of control changes from inputs and cash limits to quality, performance and output measures, an understanding of how costs vary between activities and the volume of output is crucial. Activity or volume can be measured in terms of hours worked, bins emptied, patients seen or some other proxy for output, but without a clear understanding of what is the real cost, sensible resource allocation decisions cannot be made in the short or longer term and may be made inappropriately.[4]

Controllable and Uncontrollable Costs

Most budgets contain a mix of controllable and uncontrollable costs. Determining which is which is important in budget preparation, but when we examine management control and in-year budget management in **Section 3: Achieving Your Objectives: With in-year budget management,** we see how important this is to the successful management of the budget within the fiscal year of the budget.

A controllable cost is one that responsibility centre managers can change or restrain, or for which they can vary either the level of service or level of administrative support or change other variables. An example of a controllable cost would be one where a manager in a long-term care facility could decide to order locally produced and less expensive apple juice as a substitute for orange juice. Similarly, level of service and controllability of costs are related. For instance, the number of hours an office is open can be varied to control costs. This does not speak to the need for service, but rather to how much the government can afford to give.

An uncontrollable cost is one over which the responsibility centre manager can exercise no discretion. Entitlement programs often create situations of uncontrollable costs: if an individual qualifies for some form of assistance according to the law and regulations, then that entitlement is a right, and budget-level factors have no role in that determination.

Arguably, within all public-sector organizations, all costs are controllable – at some level of the organization. The example of an entitlement being an uncontrollable cost, then, is valid only for a particular responsibility manager, not for the government that created it and can change it if costs go out of control. Let us say, for example that the responsible manager is in a district social service office, dealing with clients on a regular basis. From her perspective, the calculation of future costs must assume that the

4. The Chartered Institute of Public Finance and Accountancy (U.K.), "A Question of Cost," 1995.

entitlement levels are uncontrollable. While other elements, such as anticipated demand due to the economic situation, may be a factor in determining future budget needs, the levels are not negotiable unless the law or policy changes. From the perspective of her more senior managers, the issue is less clear. If they decide, on the basis of the severity of budget restraints or increases in entitlement program use, that perhaps the entitlement levels should be changed to reduce costs, then that becomes a policy matter that they would take to their minister or council. For them, then, these costs are controllable. Of course, the political limitations on that controllability are a factor in such calculations.

Once some determination is made about what costs can be controlled, and at what level within the organization, some responsibility can then be assigned, in order to establish control strategies. Otherwise, there is a tendency within organizations to make implicit assumptions about the controllability of costs or the capability of managers. This often manifests itself in so-called efficiency assumptions that central-budget planners will build into the budgetary process. For example, in organizations with a large staff who work 24 hours a day, seven days a week, absenteeism and the consequent need for overtime are often a problem. Control over these budgets is often a preoccupation both at the responsibility centre level and for the organization as a whole. For purposes of budget formulation, central-budget managers may project a reduction in overtime on the basis of the assumption that improving managerial techniques at the local level can produce greater efficiencies. It is assumed in this process that the operational wing of the organization will put such techniques into play and that individual managerial performance will improve. It is further assumed that the accountability systems are in place both to measure the results and to do something about them. There is often an assumption that such a reduction will have no negative effect on overall organizational performance in terms of meeting its goals. There are many assumptions in this scenario, and we can see that the budget-formulation process is often used to set in place expectations for managerial performance.

Basic Costing Tools and Definitions

From the point of view of both the responsibility centre manager charged with delivering a program and the organizational leadership trying to allocate and make best use of scarce resources, the answer to the question "how much does this cost?" is not so simple. From the perspective of the budget planner, assigning costs is a matter of judgement, compromise, and, usually, some measure of debate. A good example of this kind of complexity takes us back to the district social service office and the responsibility centre manager dealing with her entitlement programs. How much does it cost for her to deliver these programs?

Two definitions begin this process: **cost object** and **cost centre**. A cost object is the unit of service, program, organization, or good for which the cost is desired. In other words, it makes sense for organizations to spend time and energy finding costs that they need to know, either for internal management purposes or to account to their external funders, their legislature or council, or the public. The selection of the cost object can affect the accounting practices within the organization. In turn, it will have an impact on the responsibility centre manager and, potentially, the staff.

Suppose that in the case of the district social service office, the ministry has determined that the cost object of the office is the cost of serving a client, including the amount of benefit received. Alternatively, the ministry could determine that the benefit received, since it is an uncontrollable cost determined by entitlement legislation, would not be one reported by the district and that only staff and administrative costs would be considered. Finally, it could determine, as we will see below, that certain costs not in the district office are relevant to this cost object and are to be included. There is no simple determination of the cost of supporting one assistance recipient. An alternative question, which would redefine the cost object is, "what does it cost for the office to serve a single client?" Another question that would create yet another cost object is, "what does it cost for the ministry to serve a single client at this district office, taking into account not just the costs of that one office but also the other parts of the organization – including headquarters, IT support, common financial and human resources services – that provide some direct or indirect support to the office?"

The cost object tends to centre on the service, process, or program offered. It is often an important consideration in public accountability, in program evaluation, and in explaining budget decisions. As can be seen above, a workable definition that is clear and well understood is important. It is consistent with the entity principle of GAAP. As with many cost issues, determining where to assign costs and what to do with that information becomes an element in the entire managerial accountability cycle. If a cost object for the district office is defined as its costs of delivering services to its clients, then this information can be reduced to a per-unit value. This office, for instance, may have a per-unit cost of $850 per client, the actual

benefit not included. In determining this per-unit cost, the ministry will also arrive at other tools for both budgeting and performance management: a province-wide per-unit cost (if it applies a similar methodology to all district offices in the overall budget) and a comparison of district offices to determine variations in cost objects.

The definition of the cost object of the organization affects both external accountabilities and internal management. Generally, however, reliance on cost objects alone can have a distorting effect, especially if they are applied in a rigidly uniform fashion that fails to take into account local variation. It is often the struggle of line managers to get these factors taken into account. One district office may be located in a very large geographical area with many remote communities to service. Travel costs for staff may be disproportionately higher than the provincial average.

The second concept when looking at costs is the cost centre. A cost centre is a unit or department in an organization for which a manager is assigned responsibility for controlling costs. Implicit in the notion of a cost centre is that it has a manager with some form of responsibility, authority, and accountability for monies assigned to certain objects in the centre. In the case of the district office, which is a distinct cost centre, we can clearly identify the manager responsible for that centre. As we have seen, that manager may not control all the resources needed to deliver the service, often depending on regional and central offices for support services that have been consolidated within the organization for efficiency purposes.

A small organization will not have many cost centres. In fact, the entire operation may be a single cost centre. Organizational distinctions between line and staff are not great. A single responsibility manager will have all the functions needed to deliver the service or program under their control. Within larger organizations, however, there tends to be two types of cost centres: line or program centres, and staff or support centres. A line cost centre is responsible for delivering whatever it is that the organization does. (The district social service office is a line cost centre.) A support centre provides services that support the delivery of the program, provides specialized services internally to the organization, and provides oversight and monitoring capacity to the organization or control elements of the delivery process for accountability and probity purposes. Suppose that the district office manager has financial advisors in the office. These people may not work directly for her but are needed to process the financial documents that are vital to getting the social assistance to her clients. Instead, these financial officers may report to a regional financial officer who supervises staff in a number of district offices.

That officer would then be operating a support-service cost centre. The staff resources for financial officers would be displayed in the regional officer's budget, not in that of the district office manager.

The arrangement of cost centres within organizations tends to reflect the degree to which these organizations are centralized or decentralized. Often, highly centralized agencies will use common support centres prominently, with specialized staff in these units reporting through their own management structures. Operational or line managers become more dependent on these support centres to deliver their goals and do not have the resources immediately at their disposal. On the other hand, through separate support centres, the expertise is better concentrated so that specialist support services can improve services to line managers.

Cost centres, then, tend to focus on the responsibility centre manager, not necessarily on the overall program cost. While the examples offered here focus on service delivery, in many public-sector organizations, the line cost centre may not provide direct service to clients but instead be a policy operation or one involved in research or regulation. These are also line functions. The criterion for a line cost centre is not whether there is an identifiable client but, rather, if the activity is central to the mission or raison-d'etre of the organization. In the public sector, especially in government, departments and ministries are often responsible for a range of different public-sector activities from policy advice to regulation development, from intergovernmental relations to direct program delivery. They are all line functions. Supporting them would be finance, personnel, technology, facilities, etc.

Direct and Indirect Costs

Building on the previous discussion, a common way of determining costs is to ask if they are direct or indirect in relationship to the core business of the organization. Direct costs are costs incurred within the organizational unit for which the manager has responsibility, and costs of resources used for direct provision of goods or services or activities that relate to the core mission of the organization.[5] They are those costs that are associated with, or have been physically traced to, a specific cost object or cost centre.

5. Steven A. Finkler, editor, *Financial Management for Public, Health and Not-for-Profit Organizations* (Upper Saddle River, NJ: Prentice Hall, Inc., 2001), 97.

Indirect costs are costs assigned to an organizational unit from elsewhere in the organization (e.g., information technology support) and costs within a unit that are not incurred for direct provision of goods or services – that is, are not central to the core business or mission – but are nonetheless needed to provide those services (logistical support, information technology, physical plant, financial services, etc.).[6]

Similarly, indirect costs from support cost centres are often applied to several cost centres. For instance, the cost of providing IT support from the central support office will mean ensuring that the services to the line cost centres are costed in a way that provides a full picture of all the costs of the service they are providing to that line cost centre. For example, the social workers in the district office are direct costs to the program. So, too, is their supervision, since the manager does case monitoring and direct supervision. A clerk who processes claims in the unit may also be considered a direct cost because he is part of the service procedure. If the office uses a post-audit process of review wherein a financial clerk reviews a number of claims on an audit basis after they have been paid, that clerk may be seen as an indirect program cost. This will depend on how the cost centre is organized financially and on how relevant such distinctions are within a small office or organization. On the other hand, the district office manager is supervised by a regional manager, who in turns reports to an Assistant Deputy Minister (ADM) at headquarters. They have offices, support staff, and costs, but the organization would normally treat such costs as indirect in relation to the district office. With respect to the ministry as whole, on the other hand, this ADM and his organization may be seen as mission-central and, hence, all costs are direct. Where some organizations tie themselves in knots is when they attempt to distribute all indirect costs to cost centres, often dividing up central office services in such a way that defies comprehension. This process is known as cost allocation. It is an important part of budgeting in large organizations.

Often organizations fail to fully take into account all the costs of service delivery. They must identify not only the cost of various line cost centres, but also what indirect, but necessary, services and external support costs are required to ensure that the mission-central cost centres can actually perform. An indirect cost is no less important than a direct cost. Determining the full cost of services and programs requires a full appreciation of both.

The objective of sound budgeting practice is to arrive at a complete understanding of the total cost of providing the mission-critical services of the organization. This is the full-cost principle. Full cost is the total cost associated with the cost object. The full-cost principle can be varied and complex, depending on the organization. There is the added complexity that the service costs are entirely incurred by support cost centres. Increasingly, public-sector organizations, just like their private-sector counterparts, want to know how much big-ticket items like information technology are actually costing the organization. Looking at the IT support cost centres may not tell the full story. In fact, it has been well established that IT costs are highly distributed in large organizations and that direct IT costs are just the tip of the cost iceberg. In some instances, this is relevant to budget planning and accountability. For example, the district office manager, using some discretionary funds, may have a contract IT technician ready to meet occasional needs for computer assistance to the staff, in addition to the centrally provided services, which the manager feels are insufficiently funded. This is an IT cost that is incurred directly by the line manager but is not factored into overall IT costs. Other IT costs not factored into the overall calculations comprise the amount of time that staff spend repairing their own machines or doing software upgrades or virus checks. This is a work transfer that is socially and technologically driven. Costing it into the budgeting and accounting system is something very few organizations have done.

Activity-Based Costing and the Distribution of Indirect Costs

Crucial to the budget-formulation process is the way in which organizations take the previous analysis of direct and indirect costs and assigns them to cost objects. This is known as activity-based costing, a process that, as already noted, is important but can demand organizational time and resources. Allocation of costs is the process by which organizations distribute indirect costs for a service to the cost objects of concern to the organization. In turn, it is a means of distributing centrally held service resources to responsibility centres to help them meet their program and organizational objectives. This does not mean that all allocations of costs will result in the resources coming under the spending authority of the responsibility centre manager. Rather, it is an allocation that is retained by the support or staff centre responsibility manager but notionally allocated to show how these support services are distributed across various units. A simple example of activity-based costing would be the assignment of centrally paid cleaning costs

6. Ibid.

to the various units in a building of the organization. Let us say that there is one contract for the building, valued at $300,000 annually. The building is used by three units, Unit A using 40 percent of the office floorspace, Unit B using 20 percent, and Unit C uses 10 percent. Note that this does not equal 100 percent. That is because 30 percent of the space is considered common space – washrooms, common meeting rooms, cafeteria, corridors, lobby, etc. We can see how activity-based costing soon gets complicated. So, what to do? An easy solution would be to allocate the common spaces proportionally to the office use. Therefore, costs would be distributed as outlined in **Figure 5.8, Distribution of Indirect Costs: Activity-Based Costing.**

Figure 5.8
Distribution of Indirect Costs: Activity-Based Costing

Unit and % Office Space Use	Allocation of Cleaning Costs: Office Space	Proportion of Common Space Based on % of Office Space Use	Allocation of Cleaning Costs of Common Spaces
Unit A: 40%	120,100	57%	51,300
Unit B: 20%	60,000	28%	25,200
Unit C: 10%	30,000	14%	12,600
Totals	210,100		89,100

This simple example is a testimony to the high potential for complexity in arriving at the worthy goals of the full attribution of costs through activity-based costing. Clearly the allocation of the costs of the common spaces is arbitrary. What if one of the units has more employees relative to the space allocated? What if a prime feature of the common space, the lobby, has a service desk run by one unit, which would make it a more demanding user of cleaning services. Finding common ground for allocation of costs is a challenge, but one that is worth the effort if true costs are to be determined.

In terms of external reporting, an accurate display of costs provides the information that budget decision makers want when they review past performance and future funding needs. In addition, the public and stakeholders need a full picture of the costs to avoid either deceptive allocations to reduce program costs or fail to expose cost risks. Internally, a number of dramas play themselves out over the allocation of costs, some of which are described in more detail in **Appendix 1** and may explain, in part, why people think it is important to play these games.

In complex organizations, there is often a struggle to get organizational resources that managers do not directly control although they need the means to get the job done. For example, training for staff may be under the control of the organizational training manager but of great interest to line managers wishing to keep their staff accredited for their work. Getting what they need involves negotiation and persuasion as much as rational need. Often the level of indirectly controlled resources will affect the capacity of the manager to deliver on program needs. For example, the manager who may have some staffing authority cannot move forward with new office space over which he has no control. Meeting his objectives depends on getting these resources.

The distribution of indirect resources may also be seen by managers as a question of fairness and equity. Often indirect resource managers will work hard to develop formulae, so as to be seen to be distributing resources fairly. Major plans for capital and equipment replacement will work on a cyclical basis to ensure that all units are treated fairly over reasonable periods of time. Costs of managing contracted service agreements or the costs of outsourcing have to be taken into account as indirect costs to the organization. While they are indirect, they are real and have to be weighed when considering the use of external services. An example is the overhead charge applied to the direct cost of delivery for educational programs that universities offer to other organizations. The overhead charge can vary but is considerable, often reaching 30 percent of the direct service charges.[7]

Managers will want to avoid the distribution of indirect costs that inflate their cost-object levels to their disadvantage. This relates directly to the treatment of overhead costs that do not affect direct delivery and are therefore not a real concern of managers, either in delivery on accountabilities, or in getting their fair share. Such costs as auditing, various headquarters offices, or communications budgets may not be particularly popular with managers.

The terms overhead and indirect costs are often used interchangeably, with the former more commonly used by the media and public, carrying a connotation of unnecessary waste. One also still hears the term administration used in this way. Public-sector organizations are often faced with the accusation that they waste too many resources on overhead or administration, to the detriment of service delivery.

7. A good example of a well-articulated policy on direct and indirect costs for contract services costs is the University of Victoria's policy. See http://web.uvic.ca/uvic-policies/pol-1000/1170ESCP.html

Volunteer organizations have faced considerable scrutiny of their administrative costs over the years. Donors and funders increasingly demand evidence that their funds are going directly to the specific client groups for which they are intended and not towards operations of the office or administrative costs. Similarly, even public-sector funders of volunteer agencies have adopted the same approach, often refusing to support what is generally called sustaining funding, associated with the costs of the office and the executive director as opposed to direct client service. This is short-term thinking that ignores the vital role that legitimate support services provide to service delivery.

For government, the issues of overhead cover a range from minister's vehicles to central offices where people have never seen a client, let alone have any experience of what actually happens on the front lines. However, that does not mean these activities are superfluous. They are part of the operation of large organizations. Overhead, seen from an accounting perspective, refers to expenses such as these that are not part of the direct operations or service delivery of the organization. Taken a bit more positively, overhead costs are incurred for the common goals of the organization. These will benefit, or have an impact on, multiple programs that the organization administers or the organization as a whole. This creates a dynamic within larger organizations in which responsibility centre managers will resist attempts to allocate indirect costs that they see as unnecessary or unhelpful to their direct responsibilities. Still, public accounts committees and auditors general will want to know the actual costs of overhead.

The fact is that there are legitimate reasons to allocate overhead costs, even those costs that managers may not directly find helpful. Some of these have been outlined above. The simple reality is that behind every good program there must be a sound organizational infrastructure supporting its delivery. In other words, programs do not exist on their own. Rather, they depend upon the organizational infrastructures in which they are housed. They are products of governance, management, and complex funding arrangements. An organization's ability to provide services relies on a host of indirect expenditures.

Governments seldom are engaged in just the delivery of a series of services. What counts is not simply a matter of what is being delivered but also of how it is delivered. This requires a degree of accountability, reporting, and record-keeping, none of which is generally regarded as a direct cost. For example, internal audit as a form of control is an indirect cost that responsible public organizations must have. Further, large government departments serve a variety of masters, not the least of whom is the minister. That minister needs logistical support, policy advice, planning, and communications in order to satisfy his accountability and answerability for the department's activities. These are not glossy add-ons, but part of the workings of the public sector. Unfortunately, there is no magic ratio or formula to establish an appropriate level of overhead for an organization.

The danger is in ignoring overhead or indirect costs in order to sell a program. A good example is the penchant of politicians over the past three decades to support an increase in the number of police officers on front-line service, often characterized as "boots on streets," demanding that all the funds allocated to enhanced public safety be for those officers. This ignores the reality that a frontline police officer depends upon an array of services and infrastructure to get his or her job done. Seldom do officers arrive at a scene or walk a street without all communications systems working. In fact, any officer who did so would be negligent. Further, they depend increasingly on sophisticated information technology and geo-spatial tracking to link the current actions with known patterns and other crimes. These are all indirect costs.

Fixed and Variable Costs

Analyzing fixed and variable costs enables the planner to determine how costs will react when certain program assumptions are changed. It can establish cost sensitivity, i.e., the point at which costs are reduced or increased with changes in activity. Establishing an understanding of cost sensitivities will enable the manager to better understand the impact of program changes. While we have already explored the issue of direct versus indirect costs, it does not follow that all direct costs are fixed and all indirect costs are variable. Fixed and variable costs are the two components of the total cost of an activity. Total, or full-cost, information is important in setting the price or internal cost of a service and in assessing the organization's capacity to absorb increases or decreases in either resources or levels of output. A fixed cost is one that does not vary with the volume of use. A variable cost is one that does vary with volume of use.

Understanding fixed and variable costs is best done with a good example. Here, we have used material published in 1989 by the Physician Payment Review Commission, based on a study done just after the US federal govern-

ment's program of Medicare started paying for screening mammograms.[8]

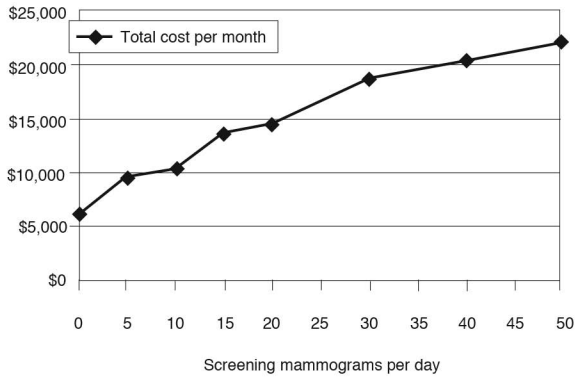
To determine fixed and variable costs, information is required. To start, **Figure 5.9** shows the total cost per month of providing different numbers of screening mammograms per day.

Figure 5.9
Total Cost of Mammograms per Month

Output Rate – Mammograms per day	Total Cost $
0	6,172
5	9,462
10	10,337
15	13,627
20	14,502
30	18,667
40	20,417
50	22,167

However, this total-cost table is just a summary and provides little understanding of the nature of the costs of providing this service. Seen in chart form in **Figure 5.10,** this same information looks like this:

Figure 5.10
Total Cost of Mammograms per Month
(Chart Form)



One of the preliminary conclusions that one can reach is that total cost is indeed a function of quantity of service offered. Simply put, as the number of mammograms rises, so do the costs. But, how? Is the increase on a cost-per-service, or is there a mix of costs that change differently, some affected by volume and some not. This is important in cases like this where there is often a heavy investment in capital equipment to serve this vital need. Having this equipment will cost so much regardless of use in many cases as it will need to be maintained, upgraded, etc. This equipment, however, is totally dependent on having qualified staff to run it. That cost will vary based on demand and the number of hours the organization is prepared to have it in use.

Fixed costs are those costs whose total does not change as the number of service units changes over a relevant range of activity.[9] It is interesting to note that costs are incurred even at zero delivery of service, principally because of the capital costs involved.

Figure 5.11 sets out the capital costs of providing screening mammography; that is, the capital outlay required before the first patient is seen.

Figure 5.11
Capital Outlay Required

Capital Outlay Required Before the First Patient Is Seen	
Mammography unit and processor	$80,000
Start-up supplies	2,000
Property improvements	15,000
Furniture	5,000
Office equipment	3,500
Miscellaneous	500
Capital outlay — total of above	$106,000

It may be asked why the total cost from **Figure 5.9** for a zero level of service is $6,172 instead of $106,000 to start. This is an application of the accrual principle, which requires that we convert a one-time capital outlay into a cost flow over the time that the equipment is used. We do that by imagining that we borrow the money and then pay back the loan over a period of years at so many dollars per month. Hence, the cost of capital, based on its anticipated depreciation rates, would be reflected as a fixed cost for the period of six years, which is the reasonable life expectancy of this machine. The cost of capital is also calculated to take into account the borrowing of money to pay for the

8. Samuel L. Baker, "The Costs of Providing Screening Mammography," University of South Carolina Arnold School of Public Health, Department of Health Services Policy and Management, HADM J712, Sept. 4, 2002.

9. Finkler, *Financial Management*, 99.

equipment at a 12 percent rate of interest for six years. This calculation indicates that the amortized cost of the equipment each month is $2,072, which represents the monthly fixed cash flow associated with our initial capital outlay.

The overall figure of $6,172 per month includes other fixed costs per month (from **Figure 5.9**). **Figure 5.12** sets out these other costs that recur monthly, independently of how many patients use the machine.

Figure 5.12
Other Fixed Costs

Other Fixed Costs per Month:	
Maintenance	$ 425
Promotion	250
Accounting	100
Insurance	100
Rent	875
Telephone	100
Taxes	750
Clerk/receptionist salary and benefits	1,500
Total other fixed costs per month	**$4,100**

Taken together, the fixed cost of the capital and the other fixed support costs make up the total fixed cost of operating the machine for a month, as seen in **Figure 5.13**.

Figure 5.13
Summary of Fixed Costs

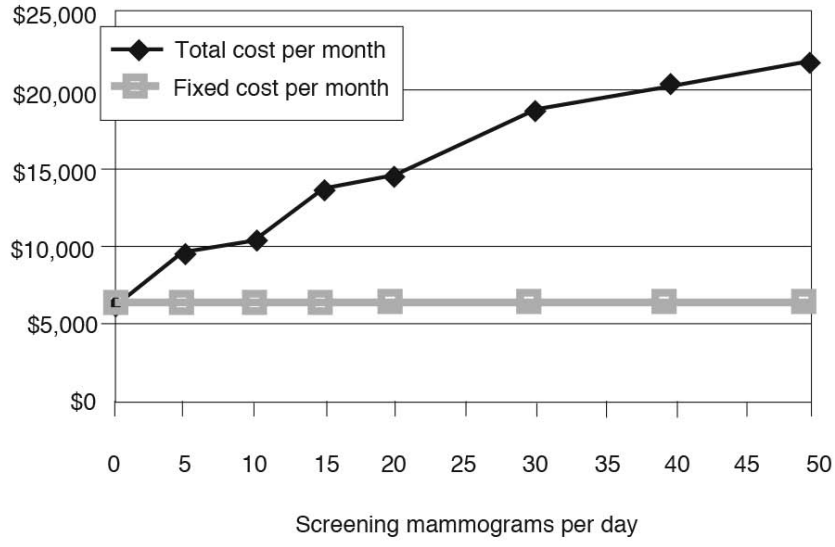
Monthly capital cost	$2,072
Other fixed costs	4,100
Total fixed cost per month	$6,172

Adding this fixed cost information to the initial table on total costs begins to show more useful information. Note in **Figure 5.14** that the fixed cost is the same for all output ranges, even if the output is zero.

Figure 5.14
Fixed and Total Costs, in Table and Chart Form

Output	0	5	10	15	20	30	40	50
Total cost ($)	6,172	9,462	10,337	13,627	14,502	18,667	20,417	22,167
Fixed cost ($)	6,172	6,172	6,172	6,172	6,172	6,172	6,172	6,172

In chart form, the same information looks like this:



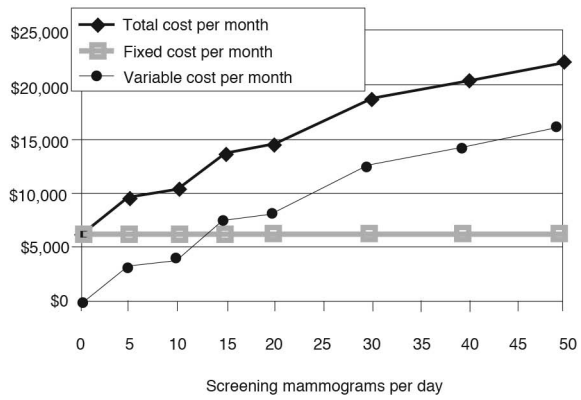
Now we come to variable costs: costs that vary directly with changes in the volume of service units over a relevant range of activity.[10] In the case of the mammogram program, it is assumed that the unit will be functioning 20 days a month. This is an assumption that itself can vary, but it reflects some of the givens that may have to come into play before "what if" scenarios on costing can be developed. Theoretically, a mammogram machine can, with minimal changes in fixed costs, operate 24 hours a day, seven days a week, although many factors will mitigate against that happening. Building in that assumption of 20 days of use each month, variable costs work in this scenario as indicated in **Figure 5.15**.

Figure 5.15
Variable Costs Broken into Categories

Variable costs (in dollars) per month (20 working days per month)								
		Tests per day						
Cost category	**Unit cost ($)**	**5**	**10**	**15**	**20**	**30**	**40**	**50**
Radiological technologist		2,415	2,415	4,830	4,830	7,245	7,245	7,245
Film	3.00	300	600	900	1,200	1,800	2,400	3,000
Medical records	2.00	200	400	600	800	1,200	1,600	2,000
Supplies and miscellaneous	2.00	200	400	600	800	1,200	1,600	2,000
Postage	1.00	100	200	300	400	600	800	1,000
Forms	0.75	75	150	225	300	450	600	750
								15,99
Total monthly variable cost		3,290	4,165	7,455	8,330	12,495	14,245	5

An astute reader will note that the monthly variable costs are equal to the difference between total costs and fixed costs for each output level. With variable costs presented graphically in **Figure 5.16** and combined with the fixed costs, we come to a better explanation of the total cost figure initially offered:

Figure 5.16
Total-Cost Figure with Fixed Costs



10. Ibid.

As displayed in **Figure 5.17**, the final element of analysis is to derive, from total cost, the average cost of one mammogram based on the changing cost assumptions.

Figure 5.17
Average Costs

Tests per day	Tests per month	Total Cost ($)	Average Cost Per Service ($)
0	0	6,172	N/A
5	100	9,462	94.62
10	200	10,337	51.69
15	300	13,627	45.42
20	400	14,502	36.26
30	600	18,667	31.11
40	800	20,417	25.52
50	1,000	22,167	22.17

It is no surprise that average costs go down as volume increases. This assumes that the demand is present, the resources are in place, especially the human resources, and that there is accessibility.

Break-Even Analysis

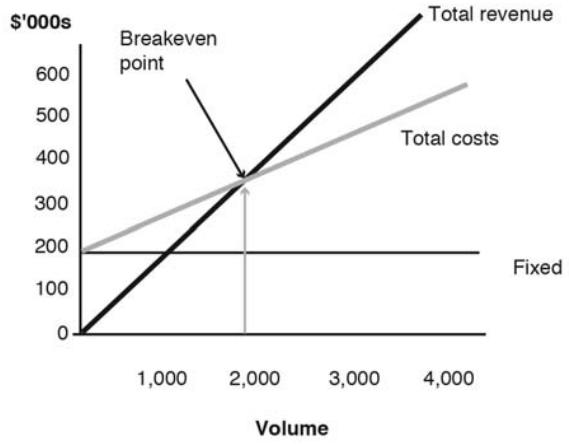
Of particular importance for nonprofit organizations, or for those in the public sector that have a high degree of revenue dependence, is the analytical tool of break-even cost analysis. In addition, public-sector organizations that depend on funds based on the volume of services they provide can use this tool. For any of these organizations that are anticipating providing a new service as part of their program, the break-even analysis will provide some indicator of the volume of service provided and the levels of revenues that are needed to make it self-supporting. Knowing this will enable the organization to make a reasonable determination of whether it can actually make this new service happen.

Essentially, break-even analysis costing is a means of determining the level of income based on such variables as rates charged, fees and anticipated volume the organization must the anticipated costs of the service. Calculation of the break-even point is based on the formula:

TR (Total Revenue) = TC (Total Costs)

Costs are made up of fixed and variable costs as described above. **Figure 5.18** graphs these costs for a hypothetical example.

Figure 5.18
Break-Even Cost Analysis



One can readily see how volume represents an important variable, especially when it is possible to generally control other factors through management and allocation. The volume in these cases is often dictated by near-market demand forces beyond the control of the organization or the unit proposing the delivery of the service. It will therefore have to convince its funders that these volumes are attainable if the service is to be worthwhile.

For the manager trying to develop a cost for a service, or inversely the level of service that can be offered with the funds available, break-even analysis is a useful tool. It can work both ways. The fee for a service will depend on all costs, fixed and variable, along with an anticipated volume calculation. On the other hand, where funds are constrained (which is pretty well all the time) or fees on constricted (government limits on tuition is an example), volume of services, based on the calculation of the individual service is then defined, regardless of demand.

Appropriation Process: Getting Approval to Spend

It should be clear by now that a budget is a plan that builds on a strategic outlook, costed and analyzed for decision making. It is also the way in which these aspirations are finally defined and, in some cases, confined to what is financially possible. It is also a means for setting priorities among all these public goods that are wanted by the public or advocated by public servants or politicians. As the process becomes more institutionalized, as in the Expenditure Management System of the Government of Canada, it engages more players and eventually becomes the formal

budget submitted to the authorizing authority that has the power to allocate funds and permit their expenditure. In the case of governments, this will be a city council, a legislative assembly, or Parliament. In the case of a nonprofit organization, it will be the board of directors or governors. In many cases, the formal budget will also be scrutinized, and possibly subject to some form of approval, by a more senior level of government, or by a government funding a nonprofit public-sector organization such as a hospital, or by the principal funders of a program.

The purpose of these submissions is to obtain specific approval to spend money. Such authorization is called an appropriation. In some cases, the terms "voting supply'" and "approval of the estimates" create the authority to spend funds. An appropriation is the approval by a legislative body of an organization's budget. Appropriations create the authorization for spending the amount in the budget. From it flows the important legal authority for individual managers to spend public funds.

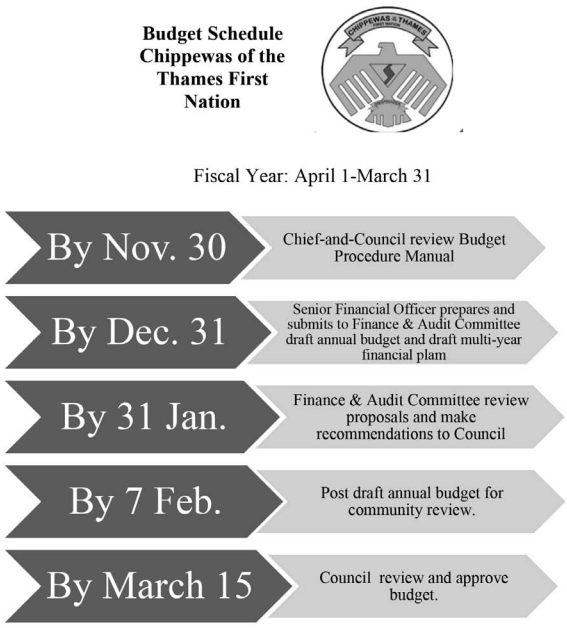
The roles of legislatures, however, are not restricted to votes for or against a particular budget plan. They have a number of other functions that will affect the outcome of a particular budget planning cycle, such as:

- Engaging in consultation processes, including setting up public hearings on budget priorities for the government
- Detailed scrutiny, at committee level, of individual departmental spending plans, including hearing from the minister and officials as well as interest groups
- Detailed and open decision making (most notably at the municipal level) of budget plans presented by departments in advance of their approval
- Proposing changes to appropriations for individual departments and submitting these to a committee vote and subsequently to a vote in the legislature (this is more likely to happen in minority government situations)
- Hearing from the legislative auditor, most notably the auditor general of the jurisdiction, on her views of the financial management of the government, which will have an impact on future budget behaviour
- Holding hearings and investigations into specific aspects of the budget that may cross departmental lines but be of direct relevance to taxpayers; for example, the impact of various user fees by different departments on economic development and small business. Such hearings bring public attention to such issues and often affect future government behaviour
- Reviewing past financial and program performance by means of departmentally generated performance reports.

Legislatures, then, can be very active participants in the budget cycle. The degree of that participation varies across Canada, but it is clearly increasing as the budgetary process becomes more open as it has been doing for the past twenty years.

Most governments will set a budget cycle schedule to guide the work of their bureaucracies in reaching timely decisions. An example of one such schedule is found in **Figure 5.19, Budget Schedule of the Chippewas of the Thames First Nation.**

Figure 5.19
Budget Schedule of the Chippewas of the Thames First Nation


Budget Schedule
Chippewas of the
Thames First
Nation
Fiscal Year: April 1-March 31
By Nov. 30
Chief-and-Council review Budget Procedure Manual
By Dec. 31
Senior Financial Officer prepares and submits to Finance & Audit Committee draft annual budget and draft multi-year financial plam
By 31 Jan.
Finance & Audit Committee review proposals and make recommendations to Council
By 7 Feb.
Post draft annual budget for community review.
By March 15
Council review and approve budget.

Inherent Tensions in the Budgetary Process

The budgetary process is inherently value-laden and rich in conflict. As we describe planning processes, the need to plan and translate policy into resources, various roles of the executive branch and legislative or oversight branch (legislature, council, board of directors) of the public-sector organization, it would be naïve not to realize how many pressures are engaged in the budgeting process. These

tensions also have a significant impact on the substantive outcomes of the process itself.

Balancing Revenues and Expenditures: Financial Discipline

For all public-sector organizations, the primary tension in budgeting oscillates between aspiration and capacity. Of course, the same can be said for any individual or household budget: ideally, expenditures should at least equal revenue. Public-sector organizations have to make that equation work. Often, they will do so via a mix of adjustments to both revenue and expenditures, including changes in taxes and fees to increase revenue, and changes in program levels to reduce expenditures as well as incurring debts to cover the difference. This is a complex process because governments, as we have noted, have debt capacities unrivalled in the economy. They have been able to extend program expenditure by increasing debt, often leaving the country or province with large debt burdens. Similarly, they have been able to add fees, secondary taxes, and user charges – all forms of taxation, voluntary or otherwise – to expand their capacity. An example of this is the relatively recent decision in many North American governments to increase their dependency on revenues from publicly licensed casinos.

On the other hand, tremendous pressure exists to restrain the growth of taxation in any form, and of the size of government as a whole. Some of this derives from a strong belief that government is too large and does too much and that the private sector should be used to move so-called public goods into the market. This has manifested itself in legislation in many provinces to cap tax increases and government spending.

Some of the pressure to reduce is a response to debt load: while governments can expand their scope through debt, they have to pay for it. Costs for debt service in the mid-1990s reached crisis proportions in many countries, including Canada. Once again, in response to the Great Recession of 2008, governments took on significant debts to fund stimulus spending. As a consequence, they then had to address means to reduce expenditures to eliminate the operating deficits this created and, eventually, pay down the debt. High debt has two effects: it forces measures to reduce dependence on debt, and it diverts revenues from actual program expenditures into debt servicing. **Chapter 7, Shifting Priorities: Reallocation and Budget Cutting** will address these issues at both the government and individual program level.

The Wants Versus the Won'ts: Central Agency Versus Program Advocates

Very few public-sector organizations are monoliths, acting on the same set of values and impulses to achieve the same set of goals. Large governments are complex entities with central agencies that take a whole-of-government view in their efforts to bring coherence to a myriad of programs, agencies, departments, and available funds. They also have the parts of the whole – program departments – seeking to maximize their own resources to improve their program capacity to achieve the public good for which they were created. As Wildavsky says, "Every agency wants more money; the urge to survive and expand is built in."[11]

There are many motivators behind this desire for more resources: some of these involve genuine assessments of program needs; some involve stakeholder pressures; and some involve power and prestige. Some involve all of the above. It is a rare day when an agency of government offers up funding to a central agency or finance department for the greater good or for another department's use. Generally, most public-sector organizations are dealing with a demand that they cannot meet, so they need more resources in order to try to do so.

Central agencies of government and other large public-sector organizations take a more corporate view. This can translate into trying to enforce spending limits on the overall budget. It can also result in efforts to find funding in one program area to transfer to another one, or to transfer the funding to new initiatives, otherwise known as reallocation. This tension plays out at both political and bureaucratic levels. Ministers may be seeking funding for their particular initiatives, while the central agencies may see this as a dangerous drain on scarce funding. They may push back on the ministers to find funds within their own departments. Departmental bureaucrats may argue that no such funding can be found in an already stretched budget. So goes the merry-go-round of dispute that is often resolved through a compromise involving a number of strategies that include new funds, reallocated funds, and program adjustments.[12]

Central agencies also have the demanding role of reconciling overall supply of funds – the revenue side of public expenditures – with overall demand – budgetary requests from departments. One of the underlying strengths of a

11. Wildavsky, *Budgeting: A Comparative Theory of Budgetary Process*, 12.
12. For a useful recent overview of public-sector fund reallocation, see Joanne Kelly and Dirk-Jan Krann, *Reallocation: The Role of Budget Institutions* (Paris: OECD Publishing, 2005).

good budgetary-planning system in complex public-sector entities is that the central assessment of the supply of revenue can condition and restrict the demand for program expansion. It also ensures that debt, one of the default options (along with increased fees and taxes) when all revenues are spent, is avoided.

The New Versus the Old

Budgets are often about announcements, changes, improvements, the state of the economy. Political or bureaucratic leaders find very little appeal in announcing that they are carrying on, paying their bills, or ensuring funding for the programs everyone knows about. There is, therefore, a tension between the cost of current programming and the cost of innovation and change. While most budgets remain incremental at their core, neither incremental moves up or down ensure that this is sufficient to carry on the level of service that the organization has announced either in its budget or in some other planning document.

Nowhere does this tension between new and existing programs show itself as more problematic than in maintenance and capital reinvestment in existing programming and infrastructure. It is often the case that public-sector organizations will take a cut in maintenance budgets as an easy means of reducing the budget. This creates a deferred maintenance inventory that piles up over time. Similarly, capital upgrades of vital equipment and systems can be underfunded so that program levels decrease or, in one of those twists of long-term costs for short-term savings, maintenance costs rise because of deferred capital replacement. So, too, do risks that the infrastructure will deteriorate and create dangers to the public. Often, as is the case with much of Canada's water infrastructure, such delays only increase costs. In some instances, bridges and overpasses for example, governments have had to scramble to launch massive restoration efforts following tragic collapses of one or two such structures.

Robust planning systems along with accrual accounting and budgeting should incorporate ongoing costs, including maintenance and capital replacement, and factor depreciation into their calculations. That still does not make them exciting or politically appealing. The role that public-sector organizations play in conserving public infrastructure and service levels is, in the end, a political one. The allure of the announceable or the legitimate need to respond to emerging demands will always create tension between the new and the old.

Robbing Peter to Pay Paul: Moving the Money Around

Perhaps one of the greatest sources of tension within budgetary systems is the desire by governments to extract funds from one spending centre and move it to another. While this goes by many names, it is generally known as reallocation of existing funds and is often a matter of funding new programs with existing funds. However, it can serve several purposes, which will be explored in Chapter 7.

Complexity Versus Clarity

Budgets are made up of a stream of decisions, some that involve spending and some that involve limiting spending. It is seldom the case that this stream of decisions is totally clear. Very few decisions are alike, and a variety of political, social, and economic factors come into play in their creation. For many public-sector organizations, achieving the objective of public involvement and transparency can make the budget process a long one, involving many different forums to arrive at a final product. Budget making is complex. Understanding the process itself takes some skill. Managing effectively within it takes another set of skills.

Such complexity can drive out clarity of purpose unless there is a strong, singular force at play. With budget cutting, it is often the force of the simple objective that prevails against the complexity of a planning and budgeting process that, left to its own internal dynamic, would have produced a result quite different from that wanted by the leadership. In other words, regardless of the process design, it is often necessary to cut through all this if there is an urgent need to make changes, especially to reduce budgets.

The tension in the process becomes how to instill clarity into a necessarily complex process. As we shall see, this often means limiting spending options well in advance of the beginning of the process. It can also mean resorting to across-the-board solutions that produce the satisfaction of achieving one result at the cost of vastly distorting program priorities along the way. Regardless, budgetary processes that run on their own dynamic without direction and leadership will land in a very uncomfortable place. It will force leaders to make decisions contrary to the demands presented to them, which takes strong political will and the potential loss of many allies along the way. It can also take strong bureaucratic will when the decision-making process is within the organization. Coalitions also have to be made, rebuilt, and occasionally abandoned to achieve internal budgetary ends.

Summing Up: Trends to Watch

The process of formulating and getting approval for a budget, at any level and in any kind of public-sector organization, is an integral part of how that organization carries out its mission. While it can be complex or simple, depending on the nature of the organization, some common elements for public-sector organizations emerge:

- Budgets bring together needs and capacity, often from different parts of the organizations, be it tax capacity and program demands, or client needs and the fundraising capacity of the organization.
- Budgets demand a technical command of the key elements of needs measurement, effective costing of programs, and revenue projections.
- Budgets in the public sector are legal documents that define expenditure authority and limit it to those levels once approved by the authorizing legislature.
- Budget making takes place in an organizational culture, rich in nuance, with power playing as much a role as good policy making.
- Budgets are inherently transparent in the public sector, in terms of both how they are formed and how they are executed.
- Budgets are the result of both planning based on past experience and the existing policy or mission framework of the organization and future orientations.
- Budgets in the public sector are subject to intense scrutiny, not only by those who will manage them, but also by those who will benefit from or be subject to them.

Some of the trends that have manifested themselves around the world are starting to take hold in virtually all forms of public sector budgeting. Some of these are:

- Accrual budgeting will enhance the requirement for full life-cycle costing but also add considerably to the complexity of the budgeting process.
- Integration of capital and operating budgets as a result of accrual budgeting and other demands will result in a great link of capital and the operational costs and implications of major capital decisions. This will impact the municipal and health sectors, which have tended to separate such budgets.
- The emergence of risk analysis and mitigation will affect the budget process. This includes applying risk techniques to environmental analysis, costing, program sustainability and infrastructure capacity.
- There will be an increased commitment to multi-year budgeting and authorization of expenditures.
- Formalized tools will be used to identify budget cuts, opportunities to reallocate, and a priority setting process.
- Better links to results will be developed through new measurement tools such as those emerging in American cities and states, using measurement dashboards.

Pursuing Equity in Budgeting: Gender-Based Budgeting

The issue of how governments' budgets affect women has been an issue for many decades, most notably in the developing world. It has recently attracted some attention in Canada with the attempt by the Government of Canada to introduce it as an aspect of its 2018 Budget. Gender-based budgeting is not about giving women's programs more money. Rather, gender-responsive budgeting seeks to ensure that the budgeting of public resources is carried out in ways that contribute to advancing gender equality and women's empowerment. It should be based on in-depth analysis that identifies effective interventions for implementing policies and laws that advance women's rights. It provides tools to assess the different needs and contributions of men and women, and boys and girls within the existing revenues, expenditures and allocations, and calls for adjusting budget policies to benefit all groups. It is a step not only towards accountability to women's rights, but also towards greater public transparency and can shift economic policies leading to gains across societies.

Gender-based analysis, introduced in the 2018 federal budget, tries to identify how policies, spending and taxation measures differ for women and men. For instance, it is clear that special government employment program produce more jobs for men than women.[13]

Depending on the aim of the exercise, gender-based budget and planning analysis can be applied to:

- Show the percentage of men and women benefiting from certain budget allocations.
- Review the overall program or budgets of a particular sector such as education or health.
- Allocate resources to specific programs for women contributing to gender equality.
- Apply a gender perspective throughout the planning and budgeting cycle, from consultation, drafting of

13. Kate McInturff, Budget 2016: Not Enough Real Change for Women. See http://behindthenumbers.ca/2016/03/22/budget-2016-not-enough-real-change-for-women/

plans and budgets, to public hearings, monitoring and reporting.
- Analyze expenditures and/or revenues from a gender perspective to show who is paying for what and who is receiving what.

While gender-based budget analysis has been practiced in many countries, there is no one set of analytical tools or budgeting policies in place anywhere that fully addresses the goals of such an effort.

Taking the Longer View: Budgeting and Planning for Sustainability

The planning process means taking the long view. Aside from the objectives to be achieved in any program area, there are some underlying concerns about how effectively governments budget to sustain programs over that long stretch. The term fiscal sustainability has two distinct areas of focus:

- **Debt load**: Is the debt load of the government such that it cannot sustain operations over the long term?
- **Program sustainability**: Does the budget take into account the need to have infrastructure, capacity and sufficient operating funds to sustain the program objectives and levels of service over time?

In the public sector, a balanced current budget may not be a sign of fiscal health. Further, manageable deficits, a concept that is certainly politically contentious, may be an appropriate response by government to broader economic and policy challenges. The near-global growth in debt by governments following the Great Recession of 2008 is a good example of how governments have to respond to dramatic shifts in the economy, often not of their own making.

A balanced budget may mask many underlying program sustainability issues, such as:

- Failure to invest in public infrastructure renewal, leading either to disasters such as bridges collapsing or greater future costs of replacement and renewal
- Deferral of much-needed investment
- De facto reductions in services as normally occurring input cost increases are not considered
- A myriad of accounting techniques that mask current and future liabilities, and
- Depletion of operating and capital reserves, thereby limiting response capacity.

There is no question that governments have broad spending and borrowing capacities. This does not mean that they can freely use this capacity recklessly. There is a limit to how much debt can be tolerated. Debt walls have been hit in the past, requiring drastic government action. The 2017 Fiscal Sustainability Report by the Parliamentary Budget Office voices concern about the sustainability of the budgets of most provinces and territories.[14] However, these are calculations made by governments based on their policy objectives.

Budget sustainability addresses the medium- to long-term aspects of program and fiscal viability. It is seen from a number of perspectives, not simply that of formulating a government-level budget, but rather informing decision making at all levels of policy design and implementation throughout the entire cycle of how governments operate. Put differently, sustainability is not simply a matter of public finances, but also vital to program design and the program implementation and maintenance over time.

Interest in sustainability has been stirred by innovations in accounting and economic analysis such as accrual accounting and budgeting, the application of present value analysis to government budgets, intergenerational accounting, and fiscal gap analysis. None of these is standard budget practice, but some are likely to be built into the routines of budgeting in the future. It is also likely that countries will experiment with different techniques and that some will build sustainability analysis into the annual budget process.

Alan Schick[15] has identified four dimensions of sustainability for governments:

- **Solvency**: The ability of governments to pay its financial obligations
- **Growth**: Policies that sustain policy success and economic growth
- **Stability**: The capacity of government to meet future obligations with existing and projected revenue levels
- **Fairness**: Avoiding transferring costs to future generations or other parties.

One of the critiques of governments, however, is that often these decisions are made without due regard to the sustainability of the decisions being made in terms of a number of elements:

- Full costing of the initiative

14. See https://www.pbo-dpb.gc.ca/en/blog/news/FSR_September_2018
15. Allen Schick, "Sustainable Budget Policy: Concepts and Approaches," OECD Journal on Budgeting, Vol. 5, No. 1, 2005.

- Excessively optimistic forecasting of costs and future income
- Ignoring secondary cost impacts
- Future replacement, betterment and renewal costs
- Demographic impact on program costs, e.g., pension funds
- Cost of borrowing, and
- Failure to take contingencies and the need for redundancy into account.

Program managers have to constantly assess financial decisions through the sustainability lens. Some questions that such a lens will cause the manager to ask are:

- Are my current cost assumptions going to hold up in the future?
- Are we making short-term budget decisions that will cost us in the future?
- Is the infrastructure that we use or are responsible for being renewed and improved (betterment) to keep it in shape to deliver its present program objectives?
- Will changing the program as suggested change my cost structure?
- Will new processes or technologies affect the ability of my staff to deliver? Do they need training or will these changes fundamentally change my skill set needs?
- Do our plans take into account maintenance costs?
- Do we have an adequate system of risk management to identify those things that will affect our sustainability?

Program sustainability concerns the individual manager. It pays to plan with costs fully accrued well into the future, especially in programs that have certain characteristics:

- Heavy reliance on infrastructure maintenance and renewal, e.g., roads, hospitals, schools, major technology infrastructure
- Involve significant demographic shifts, e.g., the aging population
- Entitlement programs and insurance, e.g., pensions and health care

Chapter 6
Capital Budgets: The Infrastructure to Deliver

Chapter Objectives

- Identifying the unique features of capital budgeting in the public sector
- Learning to build a capital plan
- Understanding analytical techniques in evaluating capital projects

Why Are Capital Assets Relevant to Public Policy?

The capital assets of government, its infrastructure, is a vital part of delivering public policy. Understanding what capital is, why it is different from operating budget resources and how it is planned for, acquired and used is the second side of the budget equation. Many public services, in fact most, cannot be delivered with using capital assets. Governments plan, build and maintain the core infrastructure that keeps our society working – the roads, the sanitation and waste systems, waste disposal, transit, parks and open spaces, public buildings, information infrastructure for both internal operations and service delivery to Canadians. Many program managers in government focus their work entirely on keeping these various systems working and working well. Public-sector capital spending is extensive, providing employment in the creation and maintenance of the infrastructure as well as its operation.

Owning the right assets, managing them well, funding their maintenance sustainably, and managing risks of public capital assets, which appear on the government's Statement of Financial Position or Balance Sheet (See **Chapter 11, Financial Statements**) are all critical to the ongoing provision of high-quality, cost-effective public services. They also have a significant economic impact. Public sector infrastructure investment also drives innovation in both the public and private sector. It also supports regional development. Deficiencies in social infrastructure such as schools or hospitals can have a negative impact on the well-being of citizens. Investment by government in social infrastructure such as social housing is a form of redistribution of wealth.

As we will see, one defining feature of capital spending is that the outcome is expected to be used over a period of time that is longer than one year. While the short-term benefits of major capital investments can be construction employment, the medium- and long-term benefits can have major multiplier effects in the economy in a number of ways. This can involve lowering costs, improving efficiency, increasing productivity and enhancing competitiveness. Such investment can also support regional development.

In addition to providing new infrastructure, public spending is also required to maintain the stock of existing infrastructure to protect the value of investments already made, uphold its operating efficiency, and avoid the need for more expensive capital improvement and rebuilding.

Turning to the relevance of capital spending to the individual program manager, this will vary depending on the work of the unit that she is managing, the program itself and the tools needed to carry it out. Many program managers will have relatively simple capital needs, but they will work in organizations that have internal information, office, facility and equipment infrastructures that make the direct work of the program manager possible. Conversely, many program managers will be managing programs that are directly involved in the operation, maintenance and replacement of vital equipment to deliver a program's

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services. In this complex country with its many intergovernmental transfer programs, a program manager may be involved in assessing proposals for capital acquisitions or betterments by another government, First Nation or not-for-profit organization. Finally, a program manager, especially those in more senior positions, may be involved in making decisions about infrastructure acquisition, or investment in maintenance of a betterment, by relying upon expert advice and not being exactly certain if he understands quite fully the implications of what is being proposed. That same public manager may have to brief a minister on the proposal, explain it to a stakeholder group or consult representatives of a First Nation on the proposal.

It pays, therefore, to keep an eye on capital.

Categories of Capital Assets: Some Are Counted and Some Are Not

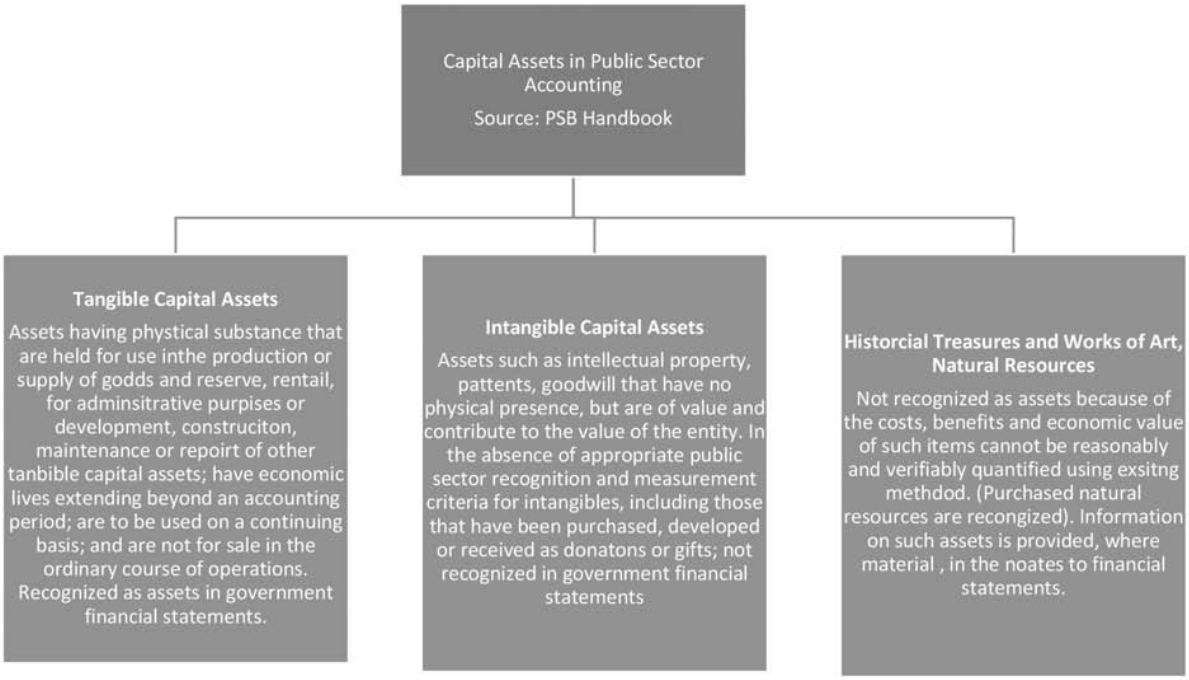
Government holds many assets. The focus of this chapter is on tangible capital assets. However, it also holds other assets that it does not recognize, based on accounting standards published in the *CPA Canada Public Sector Accounting Handbook*, certain assets due to the challenges of placing an accurate monetary value on them. These have to be recorded, but not in the financial statement of the government. **Figure 6.1, Categories of Capital Assets and their Treatment in Financial Statements**, below, outlines the recognition treatment of three categories of such assets in relation to the financial statements. Only tangible capital assets are recognized in the financial statements. However, both intangible assets and historical treasures and works of art have to be taken into account in capital budget – in reality, in operational budgeting as well – as they incur costs. These costs are expensed in financial statements. As well, depending on the material cost associated with these assets, major improvements, investments or betterments will then be recognized as capital assets as the costs are then recorded and subject to depreciation.

What Is a Capital Asset?

A not-so-scientific definition of capital is that it is stuff – the stuff that governments needed to build, buy, operate or install to make public policy goals happen. They can include such varied items as roads, bridges, major equipment, vehicles, land, infrastructure systems such as water and sewage, aircraft, missiles, computer hardware and software systems.

The definition of capital assets used by the Government of Canada is

Figure 6.1
Categories of Capital Assets and their Treatment in Financial Statements


Capital Assets in Public Sector Accounting
Source: PSB Handbook
Tangible Capital Assets
Assets having physical substance that are held for use inthe production or supply of godds and reserve, rentail, for adminsitrative purpises or development, construciton, maintenance or repoirt of other tanbible capital assets; have economic lives extending beyond an accounting period; are to be used on a continuing basis; and are not for sale in the ordinary course of operations. Recognized as assets in government financial statements.
Intangible Capital Assets
Assets such as intellectual property, pattents, goodwill that have no physical presence, but are of value and contribute to the value of the entity. In the absence of appropriate public sector recognition and measurement criteria for intangibles, including those that have been purchased, developed or received as donatons or gifts; not recognized in government financial statements
Historcial Treasures and Works of Art, Natural Resources
Not recognized as assets because of the costs, benefits and economic value of such items cannot be reasonably and verifiably quantified using exsitng methdod. (Purchased natural resources are recongized). Information on such assets is provided, where material , in the noates to financial statements.

> Capital assets are tangible assets that are purchased, constructed, developed, or otherwise acquired. Such assets:
>
> Are held for use in the production or supply of goods, in the delivery of goods and services, or to produce program outputs.
>
> - Have a useful life extending beyond one fiscal year, and are intended to be used on a continuing basis.
> - Are not intended for resale in the ordinary course of operations.

For the government, capital assets have the following characteristics:

- Beneficial ownership and control clearly rest with the government, and
- The asset is used to achieve government objectives.

For government accounting purposes, capital assets generally include any asset which has been acquired, constructed or developed with the intention of being used on a continuous basis and is not intended for sale in the ordinary course of business. Capital assets also include betterments. Betterments are expenditures relating to the alteration or modernization of an asset that appreciably prolong the item's period of usefulness or improve its functionality. "Departments shall treat as a capital asset any asset that, in addition to meeting the above conditions, has a useful life in excess of one year and a per item cost of greater than $10,000. Departments may establish a lower threshold than $10,000.[1]"

Tangible capital assets are grouped in the following categories by the federal government: land, buildings, works and infrastructure, machinery and equipment, vehicles, leasehold improvements, assets under construction, and assets under capital leases.[2]

Capital assets are treated differently from other assets in financial statements and reporting, in part, because these assets are acquired and managed differently from most operating assets. Similarly, in budget planning, capital planning takes a special place. There are some good reasons for this:

- Capital assets are expensive, involving both a considerable investment and, very often, complex financing arrangements.
- Capital assets have a long life, generally defined for accounting purposes as being of use for more than one accounting year.
- Capital assets can lock in an organization in terms of reducing alternative approaches (leasing versus building) or emerging technology (yesterday's so-called smart building may not meet today environmental standards).
- Capital assets have longer cost streams that involve the future costs of financing as well as the monies used to build or buy them.

This means that there are risks associated with capital assets that require special treatment and analysis. In terms of budget planning, capital assets and their acquisition represent certain challenges, all of which can be accommodated, but cannot be ignored. Risk for capital asset acquisition rises in the following instances:

- Project management risks, such as poor oversight, cost control, design flaws
- Technical risks, such as complex software applications, new weapons technology
- Complexity of the asset itself, especially with many interdependent sub-systems
- Strategic significance of the asset to the policy purposes of the government
- Opportunity cost risks as there is a large commitment of limited government funding, thereby excluding other potentially attractive projects from being funded
- Obsolescence risks, such as the chosen technology is overtaken by other more effective technology, the building of the bridge to nowhere, planned in one economic era and executed as circumstances changed, and, of course, the sub-set of all obsolescence capital risks, Olympic infrastructure publicly funded, built for a single purpose and then moving rapidly to white elephant status.

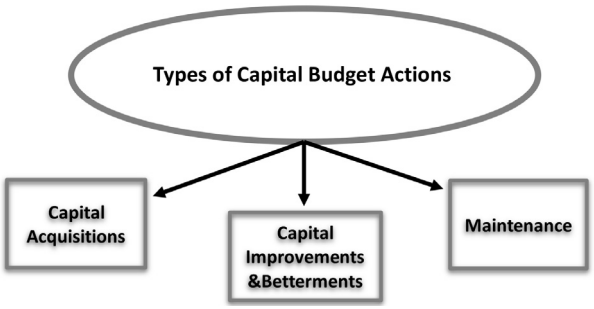
Similarly, the total cost of a capital asset over time may include sizable operating expenses. Its acquisition can distort operational planning if this is not adequately considered at the planning phase. Similarly, capital assets can be subject to **betterments,** which will affect their value, extend their life and adapt the asset to changing operating requirements. However, repairs and maintenance are necessary to ensure the original planned level of service are not betterments. For all these reasons, capital requires

1. Government of Canada, *Guideline on Cost Estimation for Capital Asset Acquisitions.* See https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=30094#appenA
2. Public Accounts of Canada. See https://www.tpsgc-pwgsc.gc.ca/recgen/cpc-pac/2017/vol1/s10/anf-nfa-eng.html

some special treatment from both the budgeting and accounting perspective. This section addresses some of those issues. It also introduces some important analytical tools and concepts that apply to decision making with respect to capital investment, such as time value of money, net present value, and other considerations of long-term financing.

In the overall management of the capital budget, it is useful to think of it breaking down into three elements, outlined in **Figure 6.2, Types of Capital Budget Actions.**

Figure 6.2
Types of Capital Budget Action



Capital budgeting and management is more than just acquiring and building things. As we have already noted and will return to many times, capital assets can last a long time. They can also be subject to wear and tear, to say the least, if the asset is a jet fighter or satellite. As most such assets today involve control and information systems, they will have to be upgraded, updated and adapted to new technology that will extend their life, usefulness and enable them to adapt to changing missions and capacity. This is the area of improvements and betterments. Finally, most capital needs to be maintained. Maintenance can take two forms: minor maintenance such as short-term repairs, regular preventive maintenance, redecorating; and major maintenance, replacing rotting concrete in highway overpasses, replacing building roofs, upgrading deteriorating sewage pipes. The former is generally part of the operating budget, while the latter is included in the capital budget.

Characteristics of Capital Assets

From an accounting point of view, resource outlays incurred on the acquisition or building of an asset, or on a transfer leading to the creation or acquisition of an asset, are included in the capital budget for so long as they meet four criteria:

- **Productivity criterion:** They are used in the production or supply of goods and services.
- **Longevity criterion:** Their life extends beyond a fiscal year.
- **Exclusive use criterion:** They are not intended for resale in the ordinary course of operations.
- **Materiality criterion:** Their treatment as a capital asset is of value; that is, many items that would normally be treated as capital, because they will last more than one year, are not. For example, a stapler usually lasts more than one year, but because of its low cost, it does not merit the special consideration that capital projects do. It is too much effort to report it as a capital asset and besides, no one cares, so it is treated as a supply and funded out of operating expenditures. Feeling free to say that "no one cares" can be translated into "it is not material."

Unlike business, governmental capital assets represent service capability or unexpired or undepreciated service potential but not future cash inflows. They seldom provide resources to pay off existing liabilities or finance future operations. As such, they are recorded as non-financial assets along with other such assets as prepaid expenses and inventories held for future use. While public capital assets are not built or bought with an eye to inflows, the disposal of capital items can produce income on the sale of land or a building at the expiration of their use. This is known as the salvage or disposal value of the asset.

There are a number of reasons to consider and plan for capital acquisition as a unique, but linked exercise:

- Time perspective is long.
- New capital assets require ongoing operations and maintenance costs, which need to be included in the larger budget cycle of the government.
- New capital assets can be debt funded, requiring consideration for governments facing large debt loads.
- Capital spending can vary from year to year, affected by changing priorities and delays in projects.

What Does It Cost? What Is It Worth?

Normally the starting value of a capital asset is the cost of purchase or projected cost of construction. Because capital assets are consumed over their useful life, accounting standards require that the use of the asset be expensed in the period it was consumed. For capital assets, this will involve some form of depreciation. The cost of a capital asset should be expensed over the time it is used. Ultimately, the asset will be used up or there may be a residual salvage

value. Calculating how much of that asset is expensed each year over its useful life involves one of three methods, depending on the type of asset being expensed:

- **Depreciation**: Depreciation is the expensing of a tangible asset over its useful life. These are physical assets as described in the text. Determining the useful life of an asset is usually subject to government policy or benchmarked standards.
- **Amortization**: Amortization is the expensing of an intangible asset's cost over that asset's useful life. The term amortization also applies to the scheduling of a series of loan payments. Canadian public-sector accounting standards do not allow the recognition of intangible assets in financing reporting. However, they are often recognized by First Nations governments to recognize the value of purchased fishing licences and other licenses.
- **Depletion**: Depletion is the term used to allocate the cost of natural resources over time.

You will find that depreciation and amortization are often used interchangeably. There is no material difference in the process itself, just in the asset to which it is applied. However, do not be surprised to find a statement like "Depreciation was amortized over the 40-year useful life of the asset."

Often, through betterment enhancement, assets have an extended life beyond the original life cycle expectation. Or, they are repurposed to meet changing needs using new technology. This means that current value has only a partial relationship with the cost of acquiring the asset in the first place. Similarly, even with straight-line depreciation, alterations and market shifts, where fair market value is applied, may mean that these assets have to be revalued for reporting purposes.

Similarly, such valuation has to be material but also feasible. Therefore, government may actually exclude certain capital assets due to the difficulty in valuation. Some examples are Crown lands that the government owns as a matter of historical right, not through acquisition, works of art or historical monuments or treasures and certain intangible assets such as patents and copyrights, although this area is highly contestable. In fact, the PSAB Handbook excludes all intangible assets for financial reporting purposes. While this rule is applied in most governments, many First Nation governments do include certain intangibles, such as fishing rights and forestry rights, as these are very valuable assets to the community and have been acquired through considerable investment.

There are several ways to establish the current value of a capital asset for accounting purposes. The first is the application of depreciation to the original cost of the asset. In this case, the asset is expensed over the useful life of the asset, most generally using the straight-line method, which allocates the cost of the capital asset equally over each year of its estimated useful value. This may include a salvage value, the residual value of the asset at the end of its useful life. The second is a variation on this as described above, that is, depreciation with betterments factored in. A betterment can increase both the value of an asset and its life. Therefore, a recalculation would have to factor in the relevant variables that would need adjustment to provide the right valuation, generally meaning adding in the value of the betterment activity to recalculate a new value, set a new life cycle and develop a new depreciation schedule. A third approach is that of fair market value. Fair market value is the result of an objective determination of the value of an asset as it might be sold in the marketplace. Often this will involve a professional assessor or the use of precedent or similar circumstances in a specific market.

In calculating the value of capital assets and how to apply depreciation, governments generally will set some standards that define what assets are to be treated as capital assets and what depreciation periods are to be applied, i.e., the standardized useful life of the asset. In this way, some degree of consistency is obtained. **Figure 6.3** shows a sample of the Government of Saskatchewan's policies on valuation of assets, and also when they are to be treated as capital assets through the application of a threshold value.

Figure 6.3
Government of Saskatchewan Capital Asset Thresholds and Estimated Useful Lives

Capital Asset Class and Category	Threshold in Dollars	Estimated Useful Life
Land	All purchases.	Indefinite
Land improvements	10,000	15 years
Buildings	50,000	25–45 years
Heavy equipment	30,000	20 years
Vehicles	30000	10 years
IT system development	250,000	10 years
Computer software	10,000	5 years
Bridge construction	All	40 years

Source: *Government of Saskatchewan Financial Administration Manual, Policy on Capital Assets Accounting and Reporting.*

Capital Planning and Budgeting

The risks in planning, budgeting and managing capital assets are real, as outlined above. Effective capital budgeting is made up of several elements:

- **Capital inventory:** This provides a picture of the capital assets, their current value, the level of need for maintenance, betterment or replacement.
- **Capital plan:** Here we are referring to the capital improvement plan or whatever the government calls it.
- **Risk oversight:** Knowing the risks, managing them and adapting as circumstances change.
- **Financing strategy:** Capital projects will increasingly involve different financing and build schemes that will affect the budget.
- **Budget:** Capital budgeting has to ultimately be part of the overall government budget, taking into account full accruals, attendant maintenance costs and replacement costs.

Governments face the challenge of marrying up their operating needs and their capital aspirations. In the absence of life-cycle cost analysis and the application of true costing tools such as cost estimation, time value of money, and return on investment analysis, capital expenditures are usually seen as an annual expenditure and not as an investment flow. In addition, making choices among capital investments has posed many challenges, especially for those governments with major infrastructure deterioration problems. For that reason, we will look at some of the analytical tools needed for capital budgeting.

Capital Inventory

It is essential that governments establish and maintain inventory systems for their tangible capital assets. These systems form the basis for accounting for those assets, for controlling how they are managed and for assessing the need to reinvest in the assets or replace them at the end of their useful life cycle. Such inventories are maintained on a continuous basis, factoring in such rules as the thresholds shown in Figure 6.3 automatically, so that the value of the asset is depreciated on a regular basis. Inventories are not taken annually, but roll over annually with adjustments.

The inventory will list all material tangible assets of the government or department. Although its form will vary across governments, it should address the following:

- Description of the asset
- Valuation of the asset
- Depreciation schedules, scrap value at end of cycle
- Lile-cycle assessments – is the asset fit for purpose
- Overall risks of assets, need for maintenance and betterment.

This information will form the basis of capital planning. But that is not all, as we will see below. What the inventory does do is focus on the needs of existing stock for maintenance and eventual replacement. This is the dull old stuff that also needs investment to keep doing the job it was built or bought for.

Capital Improvement Plans

Effective capital budgeting must begin with an effective planning process. It brings together the results of an analysis of the capital inventory with major projects to implement new policies or take advantage of program improvement possibilities. Call these the new and shiny capital assets. This will lead to the creation of a capital plan. Such a plan has a multi-year perspective and is evergreen in that, with good planning over a number of years, it can be renewed and updated rather than re-created each year. This process offers the advantages that major capital-investment depreciation is not forgotten and that maintenance issues remain on the table. It is very easy, especially in a political environment, to forget underground pipes or existing buildings in an effort to focus on more immediate crises or on the desire to create new capital projects. An example of a critical area that is emerging in this regard is the need to upgrade major enterprise computer systems on a regular basis. It may not be the most politically exciting thing, but it is necessary.

A plan is just that. The budget to fund any plan is subject to the political process, a necessary part of our democracy. Projects can be in a plan for years before funds are appropriated for them to actually be built. This is what could be called the rubber-hits-the-road test. You only know the degree of investment when you know the amount of money locked in to make them. For many governments, there are explicit rules put in place to avoid creating wish-list type plans, ones that have all the desires, aspirations and necessary investments rolled into a largely unfunded and unfundable set of plans.

In creating such a plan, a policy has to be set on what will be subject to this kind of intense review. Therefore, governments will make a distinction between a capital asset, which was described above and a supply item. In general, a government will choose thresholds such as dollar value and anticipated life of the asset before imposing capital planning requirements. Similarly, the thresholds will vary

with the size of the government. A small township will want to approve any changes to its small fleet of vehicles and have all such acquisitions listed in its capital plan. A large metropolitan government may bundle up such purchases, often with a general policy on replacement and acquisition. The key here is that capital acquisition planning is a form of control over what is seen as high risk, high return assets. Materiality and risk tolerances will be determined by the authorizing bodies such as council or central agencies. In addition, care must be taken to prevent manoeuvers to avoid full exposure of the risk and cost of the acquisition of a capital asset.

An effective capital plan will meet the following tests:

- S**trategic relevance test:** The capital project has to link to the government's goals.
- **Sound forecasting test:** What is the need? Are there projections that justify this investment and, therefore, reduction in future resources for other things?
- **Inventory and condition analysis test:** Is there an inventory of current capital assets? Has full life cycle analysis been applied to determine where reinvestment is needed? Are there agreed upon thresholds and limits for capital replacement?
- **Fit to relevance test:** Does the capital project fit with the social and political goals of the government? Are key overall planning lenses applied in the placement, design and functions of the asset: demographic and social, program changes, technology, economic, environmental, access and diversity?
- **The affordability test:** Is this well and truly costed – fully and in an agreed-to way? Are there funds available? Have all competing proposals been vetted?
- **The risk test:** What are the risks of proceeding? What are the risks of not proceeding? What are the mitigation strategies?
- **The alternative means test:** How else can this asset be acquired? How can it be funded?
- **The feasibility test:** Can this be done with the skills, resources and technology available? Is there an implementation strategy that can manage the project, execute the plan and deliver within the budget? How is this tested?
- **The governance and oversight test:** Is there sufficient governance of the acquisition that will keep it on track, make decisions in a timely manner and assess project team performance? Is there enough oversight such as project reviews, in-process audits and assessments of cost and performance reports by an external agent to give the governance assurance that things are on track?

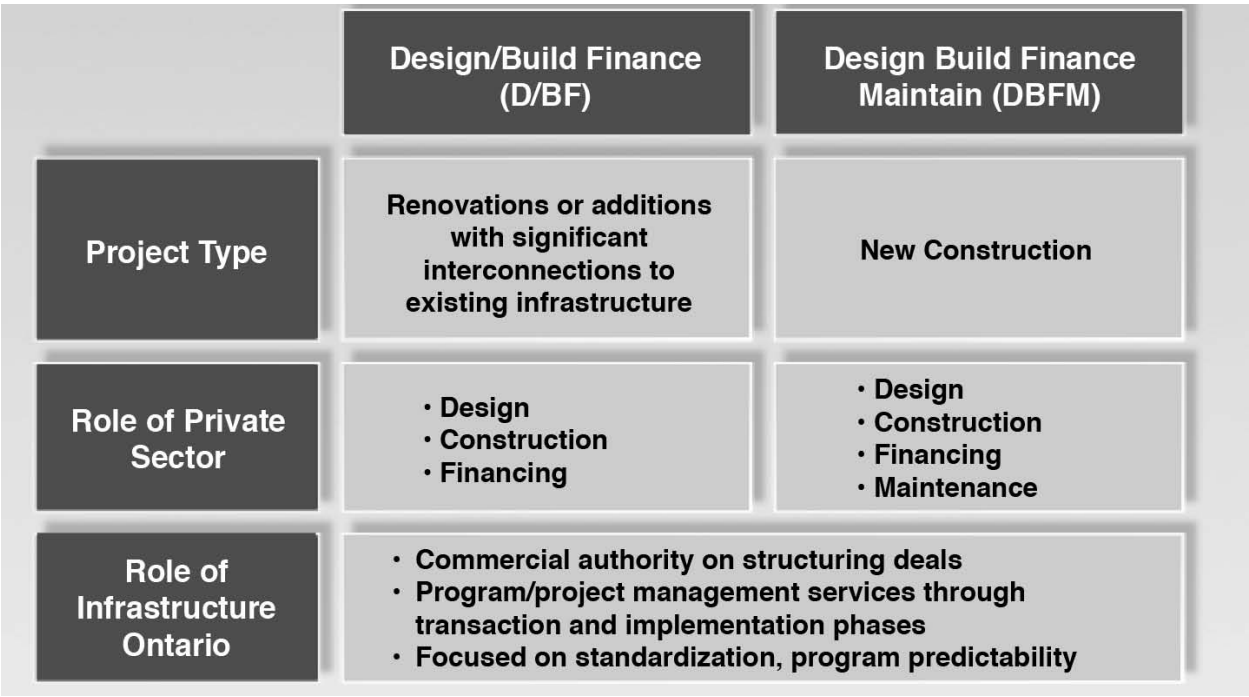
Financing of Capital Projects

Capital budgets are funded in a number of ways:

- Operating budget funds are set aside in a given year to pay for that year's cost of the project, if it takes more than one year.
- Specific capital acquisition budgets are created in the general budget.
- They draw upon designated capital improvement reserves.
- Debt through borrowing or issues bonds is often used to finance the project.
- Specialized user fees, e.g., airport improvement fees, are applied.
- Forms of public-private partnerships, described below, are used.

Governments increasingly are looking for ways to finance expensive capital projects without the use of appropriated funds, or at least minimizing their use or spreading the high impact of capital funding over many years. For instance, the Private Finance Initiative in the United Kingdom requires government agencies at both the national and local level to seek out private-sector financing for major capital projects. Similarly, Infrastructure Ontario is charged with finding new ways to capitalize major projects. These schemes take many forms, often linked to who will ultimately own the asset, and also who will operate it. How these are configured will also have both accounting and budgeting implications. For instance, a purpose-built government facility financed, constructed and operated by a private firm with the government paying an annual fee guaranteed over an extended period, will not appear as a capital asset on the balance sheet of the government. Infrastructure Ontario defines roles depending on the role of the private sector, in the following way:

Figure 6.4
Ontario Infrastructure Models for Capital Projects



Source: Presentation by David Livingston, CEO, Infrastructure Ontario. See *crgp.stanford.edu/events/presentations/cdnconsul/Livingston.ppt*

When looking at different financing and operating schemes, governments have a series of alternatives:

- **Traditional:** Governments create the capital asset, finance it through appropriations or special borrowing (bonds) and operate the asset.
- **Commercialization:** Governments create the capital asset as described above, but operate it as a separate agency that is on the balance sheet of the government, but operates autonomously or is operated, through a contract, by the private sector.
- **Public private partnership (PPPs):** Governments enter into complex arrangements for shared or private financing, building and operation of a facility that remains in the public realm and often reverts to public sector ownership at the end of the pay-back period.
- **Privatization:** Governments cease carrying out an activity. Taken up by the private sector or actioned by a part of government that has been privatized, all capital and operating spending is undertaken by the company with no direct government involvement. This does not exclude government creating regulations or rules to govern these enterprises.

It is important to note that PPPs are not privatization. This is a common error. It is also often argued, but contested as well, that involving the private sector in capital schemes increases costs and reduces government control of the asset. Both claims are contestable and controversial. What is clear is that alternative financing methods are gaining in acceptance around the world. Where they tend to fail is when governments do not play their oversight role, acting as a smart buyer of services and closely managing costs.

Risk Assessment: "What Can Go Wrong?"

Every capital or infrastructure initiative carries a certain level of risk that must be identified and managed effectively throughout its life. Life-cycle cost is just one of many factors that public-sector organizations need to consider in assessing levels of risk. Other factors include the complexity of the initiative, the organization's experience with similar types of initiative, and the nature of any technology involved. The newer the form of funding arrangement, or the greater the number of partners, the higher the risk. Similarly, organizations with a great deal of experience in complex construction projects are better

equipped to manage new capital-construction projects than those without such a background.

It is critical to understand and assess the risk involved in each initiative. Risks should be identified at the earliest stage of planning because they may affect financing and procurement options.

Once risks have been identified, they must be analyzed and evaluated to determine the likelihood, consequences, and levels of risk. Finally, a strategy must be put in place to manage or mitigate the risk (or both). Risks should also be reviewed and strategies updated as the initiative moves forward.

The table in **Figure 6.5** below shows some of the risk categories that should be considered in the planning and management of infrastructure expenditures. It also provides examples of how these types of risks may be treated to reduce the likelihood or consequences of potential losses. It is important to address these categories – and develop targeted treatments to address the specific risks unique to each initiative – to ensure best management practices. The categories listed here are among the more common ones associated with infrastructure investments.

A major risk in capital planning and implementation is poor cost estimation and the use of various techniques to mask full project costs or excessive confidence in cost estimates. There are a number of techniques that are used to ensure that full cost exposure is not made public or fully understood:

- **The salami method:** Avoid full cost exposure by introducing capital project in smaller pieces.
- **The happy face method:** Make overly optimistic cost projections.
- **The blind eye:** Ignore second costs and return with them as a separate item.

These examples are but a few of many. Governments have to clearly establish their planning requirements. They also

Figure 6.5
Types of Risk That Can Affect Capital Planning

Risk Category	Description and Treatment
General Risks	Examples include high-level concerns related to the decision to undertake an initiative. Risk treatment may include documenting how an initiative fits with established strategic objectives; assessing the requirements for a new corporate structure; enhancing the initiative's profile with the public, media and governments; and working collaboratively to enhance labour and industrial relations.
Policy Risks	Examples include the likelihood that an initiative represents, or may be affected by, a major shift in government or agency policy, or change in legislation.
Public Interest Risks	Examples include the initiative's environmental impact and its relation to public health, safety and security issues. Risk treatment may include working with neighbours and the community to address public concerns in the initiative planning phase.
Management or Organizational Risks	Examples include the complexities associated with partnerships, investments and management. Risk treatment may include managing dependencies on linked funding and contingent investments; ensuring the availability of qualified initiative managers; and ensuring the initiative development team has access to appropriate expertise when undertaking a new type of initiative.
Design/ Construction, Commissioning, Partnership or Supplier Risks	Examples include sponsor risk (e.g., the likelihood that a private partner may be unable to deliver) and general supplier/market capacity. Risk treatment may include ensuring the availability of material and equipment supplies; ensuring that experienced designers, contractors and trades are available in the required time frame; anticipating the need for community permits and approvals; and designing construction windows to avoid delays due to adverse weather.
Site Risks	Examples include the risks associated with site selection and acquisition. Risk treatment may include ensuring that the site is available at an affordable price; evaluating site challenges such as soil contamination or potential flooding; and ensuring the desired site is free of potential land-claim issues.
Financing Risks	Examples include an entity's ability to draw the required financial resources and the overall financial viability of the initiative. Risk treatment may include ensuring that financing is available at the appropriate time, anticipating the impact of interest rate increases, and evaluating the creditworthiness of potential partners.
Market Risks	Examples include all possible events that could affect cash flow during initiative development. Risk treatment may include planning for contingencies in the market such as a drop in demand for services; anticipating the potential for labour or material cost escalations; ensuring funding is available to cover operations. maintenance and administration; and assessing the potential for competing facilities.

Source: Based on the BC Capital Asset Management Framework. See http://www.fin.gov.bc.ca/tbs/camf.htm

have to define what costs must be included in getting to full project cost. They can also require third party evaluation of costs as well as a full risk analysis.

Aside from the risks in the chart above, perhaps the greatest failures in major capital projects are being over-budget and not-on-time. Delivery of on-budget and on-time projects involves a healthy recognition and management of the reasons these failures have occurred with so much regularity. Some of the sources of failure are:

- Project under-priced with optimistic timelines by project advocates
- Optimism bias in analyzing plans and risks
- Poor and inaccurate cost estimation
- Complexity of the project and the potential for "so many moving parts" to fall apart in unexpected ways
- Failure to assess availability of the skill sets in people that are needed
- Rapid turn-over in project leadership, loss of memory and know-how
- Overconfidence in supply chains, capacity to manage the unexpected and committed timelines, often bordering on the delusional
- Absence of tight project controls, oversight of the finances and project governance
- Continuous changes in the design or making additions that will drive costs up.

No discussion of risk can end with the identification of risk. Full risk management requires organizations to develop means to mitigate, manage and control risk. This is particularly the case for government. A considerable part of the planning process involves developing such strategies. Just a few of the core mitigation strategies for capital projects are:

- Effective project management
- Establishing a risk management policy and practice within the government
- Using third party risk assessment of potential partners
- Requiring fully secured financial arrangements
- Use of modeling techniques to analyze project risks
- Creation of information systems to monitor performance.

The Outcome: The Capital Budget

A capital budget, when approved, provides the authority for the acquisition and renovation of buildings, equipment, technology, and furnishings that will be used by the organization in one or more years beyond the year of acquisition. How the full project costs, which can extend over a number of years, is reflected in the annual budget, is a matter of the degree to which the budgeting process is fully accrual and whether there is a separately approved capital budget. Practice varies considerably, presenting a challenge in describing this process fairly. How public-sector organizations treat capital in their formal budget processes varies. Some have separate capital budgets, while others integrate them into their master budgets, expensing all that portion of the total project to be spent in the year being approved.

Many organizations do not report capital expenditures separately from operating expenditures in their formal financial statements. Many treat capital expenditures as current expenditures and either ignore or simply report the full costs of the capital investment through their non-budgetary planning documents. Nevertheless, their internal budgeting processes may reflect the use of capital-planning tools and approaches that are outlined here.

Simply treating capital expenditures as current expenditures taken out of operating budgets distorts the true costs of the asset acquisition. Having capital projects dependent on year-to-year approvals restricts the capacity of the organization to commit to the full cost of the project. Approving an investment in the first phase of major construction, and then reviewing it entirely without approving the next phase, can lead to a series of complications ranging from waste of public funds to a reluctance to engage in the high-risk venture in the first place. Finally, it is often the case that capital projects involve long-term debt for the organization. The challenge of long-term financing involves a good understanding of the true costs of the investment, a process of analysis quite different from analyzing operating expenditures. Accrual accounting and budgeting have led to the full capitalization of current assets and the full cost estimation of future capital actions.

As an example, adequate budgeting for, and reporting of, capital depreciation will highlight capital costs as never before. So, too, will the reporting of the current costs of debt to finance capital. **Figure 6.6**: Budget of the City of Lethbridge provides a good example of a budget presentation that combines a summary of operating and capital expenditures. Behind that summary document, it has to be remembered, is a 400-page budget statement and a separate **Capital Improvement Plan.**[3]

3. See http://www.lethbridge.ca/City-Government/Financial-Documents/Pages/Capital-Budget.aspx

Figure 6.6
Summary Budget of the City of Lethbridge

City of Lethbridge Total Budget	2011	2012	2013	2014
	$(000)	$(000)	$(000)	$(000)
Operating				
General Fund	161,782	172,301	178,455	180,274
Utility Services (billing)	3,761	3,693	3,767	3,877
Electric Utility	62,366	72,650	75,750	78,670
Waste Services	5,763	5,706	5,845	5,985
Recycling Services	1,524	1,572	1,619	1,637
Landfill	8,184	8,198	8,425	8,656
Wastewater Utility	14,661	14,725	14,799	14,873
Water Utility	20,135	20,591	21,160	21,742
Total Operating	278,177	299,436	309,820	315,714
Capital				
Transportation	23,605	23,296	15,801	10,398
Community	55,043	39,188	17,747	34,514
Water, Wastewater & Solid Waste	34,775	28,741	8,045	17,222
Electric	19,834	19,492	18,328	20,061
Total Capital	133,257	110,717	59,921	82,195
Total Budget	411,434	410,153	369,741	397,909

Source: See http://www.lethbridge.ca/City-Government/Financial-Documents/Pages/Operating-Budget.aspx

Another form of capital budget that is useful is one that shows both where the money will be spent, but also the sources of funding. The Halifax Regional Municipality is a good example, shown in **Figure 6.7, Gross Capital Budget Summary.** Once again, there is plenty of fine detail for the interested reader in the budget document.

Figure 6.7
Gross Capital Budget Summary, Halifax Regional Municipality

Budget Category	2018–19 Expenditures
Buildings	24,520
Business tools	12,529
District capital funds	1,504
Equipment and fleet	6,900
Halifax Transit	21,157
Parks and playgrounds	10,209
Roads and active transportation	44,335
Solid waste	4,750
Traffic improvements	2,680
Grand total	128,584

Project Specific Funding

Reserves	21,424
Cost sharing	2,000
Area rates and other charges	3,735
Subtotal	**25,868**

Capital Capacity	
Additional debt approved	29,800
Capital from Operating	36,200
Federal gas tax	26,500
Other (Crespool, project closures)	10,216
Subtotal	**102,716**
Total Funding	**128,584**

Tools for Analyzing Capital Costs

Big money, big risk, and a long-term perspective make it important to have good analytical tools available when undertaking capital-asset planning and budgeting. For those involved in budget processes, but not in capital planning itself, it is useful to be aware that these tools exist. The purpose of such tools is to establish the true cost of the capital project over its life as a project and then as a long-lived and used capital asset. This statement points to several elements that will certainly require commonly accepted tools to give assurance that the investment decisions being made are the right ones:

- **Costs and benefits:** Do costs and benefits match?
- **Time:** Have the changes in the value of money been factored into the calculations?
- **Value:** Is this the best value for the money?
- **Ground truthing:** Are all the cost assumptions realistic, tending towards restraint, and accompanied

by contingencies for unforeseen (some would say inevitable) increases in costs?

Many tools exist. For the purposes of understanding their scope, this text will deal with the following:

- Business cases
- Cost estimation
- Time value of money
- Cost benefit analysis.

Business Cases

Business cases play a role in both the creation of a capital plan and in the final project approval process. They provide the argument for a specific project to be included in the plan itself. They argue for its priority, show the benefits that will accrue, and demonstrate that the cost estimates, project plan, and timelines can be trusted. Large governments and public organizations will always have a multitude of challenges for their limited capital resources. Sorting out priorities mean that individual projects – and some of these are very large and complex – have to be compared with other equally (or more so in the eye of the project advocate) deserving proposals. Having a good business plan does not guarantee success of the project proposal. Not having a good business case ensures its failure.

The business case brings together certain key elements that contribute to a decision. First and foremost, the business case provides the argument for change in how the organization is going to spend its scarce resources. A good business case should serve as the foundation for an implementation plan, so it deserves considerable work to get it right. It must marry the proposed content to its costs. Therefore, quantitative analysis tools will probably play an important role. As we shall see, multi-year projects with multi-year use and benefits will require calculation of the net present value of the funds being proposed. Further, the business plan must address risks in such a way that the decision maker is confident that, even where they are considerable, there are reasonable proposals for risk mitigation.

A good business case has to answer these questions, regardless of whether it is for a capital acquisition or any other project, investment, or policy shift:

- What exactly do you want to do?
- How does it link to what we want to do?
- What is the history behind this idea? How does it link to what is happening now, or what we have tried before?
- How much will it cost? Are these costs fully inclusive and for how long?
- What are the risks you are addressing? What risks does it create and how do you mitigate them?
- What are the measures of success?
- What is the implementation plan? When and how?
- What can you stop doing that will fund this?

For many large government organizations, there will be a standardized business plan format. This certainly helps when a project advocate has to put together a proposal. It does increase the challenge of differentiation among the proposals. Making a business case unique and worthy of inclusion in a plan takes both good analysis and sound linkage to the organization's goals, both in the short and long term. The following format is representative of many examples that are available.

Figure 6.8
Business Case Format

Executive Summary
- What is being recommended
- Scope and nature of project
- Timelines, costs
- Link to overall plan

Challenge Definition
- What is the problem or opportunity
- Environmental factors
- Strategic alignment

Project Overview
- Goals and objectives
- Description
- Benefits – quantitative and qualitative
- Outcomes – what and when

Alternatives
- Pros and cons

Costing
- Project costing
- Operational implications – impact on budget

Risk Analysis and Mitigation
- Project risks
- Program risks
- Political risks

Implementation Planning
- Project management
- Timelines
- Operational impacts
- Responsibilities for outcomes

Developing the business case for a specific project in a capital plan is just the beginning of a more complex planning and approval process. However, getting it right provides a firm foundation for moving ahead but also for

garnering support along the way. It pays to subject any business case to third party scrutiny so that unforeseen risks or faulty design assumptions can be addressed.

Developing Cost Estimates for Capital Assets

In the acquisition of a capital asset, the initial capital outlay or capital cost is significant, but so are the costs associated with the use and ownership of the capital asset. In fact, these costs are often greater than the initial outlay, and they can vary significantly between options. Decision makers should be confident that the project advocates or sponsors have fully costed all aspects of the capital acquisition. In major projects, external review of cost estimates is a guarantee that this confidence can not only be experienced, but documented, and defended at a further date when auditors, assessors or political oversight bodies want information about the project.

The greatest challenge in this regard is developing assumptions about future costs. Known costs, such as the sticker price of the piece of equipment, can be readily documented. However, taking a life-cycle approach involves dealing with potential future costs in present cost and spending timeframes. See the section below on Time Value of Money and Net Present Value.

Cost estimation begins with a clear idea of what is being proposed and how it will be used. See the section on business plans above. Such clarity will entail much detail in the case of major investments. For instance, buying a fleet of high-end land vehicles for deployment in the North will need to address their use, the frequency of use, the costs of additional stresses of the northern climate, repairs and availability of people to do the repairs. All such program elements will have to be part of the cost estimation. These are called cost elements. They need to be mapped.

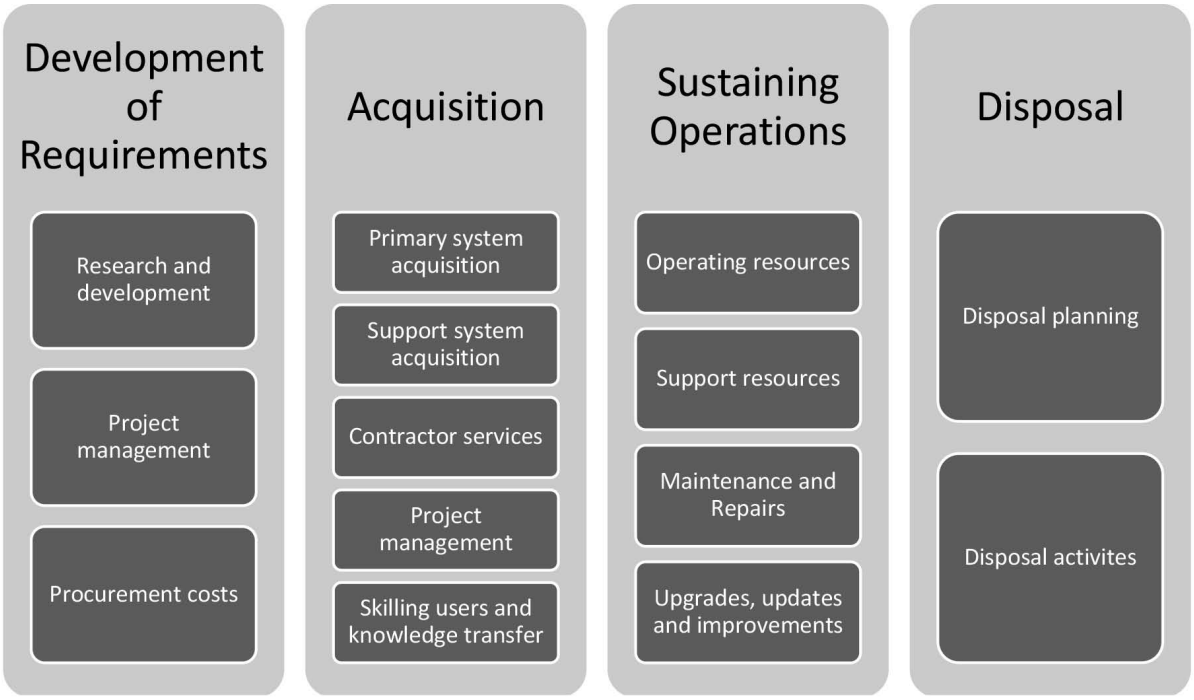
In developing a cost estimate, certain conditions have to be met:

- **Constraints in costing**: What costing rules does the government set in terms of assumptions about future costs? For instance, the government will require that inflation rates that it has set for its overall budget planning be used in project costing as well.
- **Framing expectations:** What assumptions form the key parameters of the project and affect the outcomes? These involve both outcome assumptions that are not negotiable such as timeframe and performance. They can also include assumptions that will affect cost risk, such as the assumption that a prototype design is close to being production-ready or that there will be no or minimal modifications in the equipment for it to be mission-ready. Note here how optimism bias and overconfidence can distort these so-called givens.
- **Operating assumptions:** Effective cost estimation needs to have a set of assumptions about how certain elements of the project and resulting capital asset will perform and will be managed. This reiterates the comment on the need for a good and reliable business plan. It may extend beyond, however, to such elements as:
    - Assumptions about the use, life-cycle and deployment of the asset
    - Asset requirements over its life-cycle: level of use, upgrading and betterment, etc.
    - Other assets to be in place for this asset to be useful: where is the plug for this thing, anyway?
    - Sustainability strategy in terms of maintenance, upgrades and retirement
    - Attrition plan to replace the equipment.

The structure of a cost estimation can, of course, vary. What follows is derived from the Treasury Board of Canada guidance on cost estimation[4]:

4. See https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=30094#appenA

Figure 6.9
Cost Estimation Structure



Time Value of Money

Time value of money (TVM) is important in public-sector capital planning for organizations that will have to borrow money for the project or acquisition and, hence, must know the cost of the debt charges they will be paying. Further, as they develop alternate financing schemes, the future costs of money have to be a factor in cost estimation. Alternatively, the organization may have other means available for financing capital, such as taxation, but may want to use those funds in other ways. As a consequence, TVM techniques such as net present value (NPV) can help them determine the opportunity costs associated with funding the acquisition through debt or taxation.

The simplest explanation of time value of money is that a dollar today is worth more than a dollar tomorrow or at any time in the future, and the dollar today is worth less than the dollar you had yesterday or any time in the past. Many attribute this to inflation of the worth of the currency and compounding of interest on funds borrowed. And there is a relationship, but there are other factors to consider in understanding why money has different values at different points in time. Governments have choices about what to do with the limited revenue that they have available to them: they can spend it, they can invest it, or they can hold it in a reserve. The choice they make will involve an opportunity cost. Opportunity cost is a term used in economics to mean the cost of something in terms of an opportunity foregone and the benefits that could be received from that opportunity. For instance, if a city decides to build a hospital on vacant land that it owns, the opportunity cost is some other thing that might have been done with the land and construction funds. Their choices for that dollar closely relate to time value:

- Spending it now means having the things that are needed now.
- Investing it means deferring consumption and earning a return that will increase the value of the dollar, depending on the investment and time it is held.
- Holding it, and making no decision, means deferring any use and foregoing the opportunity to either consume or earn.

Another factor that relates to the time value of money is risk. The dollar in hand today has less risk. It is firmly within the control of the organization, which can dispose of it, save it or invest it as it sees fit. The promise of a dollar tomorrow carries some risk that you won't get it or that you won't get it when you have been promised you will get it. Depending on the source of your promised dollar, there may be almost no risk, or the risk may be high. Generally, collection risk increases with distance from today, meaning

a dollar owed to you tomorrow has less risk of not being paid than a dollar owed to you next year. More things can happen to prevent the future payment in the intervening time. For instance, an economic downturn in the future could reduce tax revenue that had been planned for in the capital budget's revenue assumptions.

Interest-rate risk is also involved in the concept of time value. Market rates fluctuate, and the expectation of whether rates will rise or fall can affect loan and investment decisions. Going back to that dollar in your hand, if you think that rates are going to increase tomorrow, you could wait to invest that dollar at a higher rate than you would receive today. If you think rates will decline, your choice would be to invest the dollar today. Today's dollar, then, has more value than the one you get tomorrow for yet another reason: if rates decline, not having the dollar today means that the opportunity to invest at the higher rate was lost. As with credit risk, the amount of interest-rate risk also increases the farther into the future the payment is expected.

The final factor is inflation. If prices are rising, that dollar in your hand will buy less tomorrow than it will today. Of course, this doesn't mean that you should buy everything now, but it does need to be considered when you are making choices about what to do with the dollar and, if you invest it, what return will be needed to keep ahead of rising prices as well as compensate for not having the use of the money.

The interest rate is directly related to each of the risks described above, and is the driving force behind the fact that money has different value at different points in time. It is a variable in the calculation, but it is important to remember that it is not the *cause* of value differences, only a *result*.

Taking all these elements into account, TVM considerations become important in weighing the relative costs and benefits of a long-term capital program. The objective is to bring those costs onto a common field of analysis: present value.

Present and Future Value Calculations

Applying techniques of interest compounding and discounting, it is possible to determine either the present value or future value of a capital investment, using a simple formula that applies interest and time to the amounts that are either available now for investment in capital or the current value of a future payment. The variables used in both calculations are:

PV = present value

FV = future value

i = interest rate per period

n = number of compounding periods

Present value is an amount today that is equivalent to a future payment, or series of payments, that has been discounted by an appropriate interest rate. Since money has time value, the present value of a promised future amount is less the longer you have to wait to receive it. The difference between the two depends on the number of compounding periods involved and the interest (discount) rate that you are using.

The relationship between the present value and future value can be expressed as shown:

$$\mathbf{PV = FV [1 / (1 + i)^n]}$$

Example: You want to buy an emergency generator for the fire department five years from now for $150,000. Assuming a 6 percent interest rate compounded annually, how much should you invest today to yield $150,000 in five years?

FV = 150,000

i = 0.06

n = 5

$$\mathbf{PV = 150{,}000 [1 / (1 + .06)^5] = 150{,}000 (1 / 1.3382255776) = 112{,}088.73}$$

This shows, year by year, how the calculated initial investment of $112,088.73 will grow to the $150,000 required in the future to buy the equipment. As we can see, future value is the amount of money that an investment made today (the present value) will grow to by some future date. Since money has time value, we naturally expect the future value to be greater than the present value. The difference between the two depends on the number of compounding periods involved and the going interest rate. The relationship between the future value and present value can be expressed as:

$$\mathbf{FV = PV (1+i)^n}$$

Example: In weighing the opportunity costs of replacing a computer now or in five years, what would be the future value of $10,000 in the capital fund if it were left today in a savings account that pays 6 percent interest compounded

annually? That is, how much would you have five years from now?

PV = 10,000

i = .06

n = 5

$$\begin{aligned} FV &= 10{,}000\ (1 + .06)^5 \\ &= 10{,}000\ (1.3382255776) \\ &= 13{,}382.26 \end{aligned}$$

This breaks down the above calculations, year by year, to show what your initial investment would grow to in five years.

Applying these formulae to capital projects in the public sector is a way of analyzing alternatives. For voluntary organizations that have a direct interest in the cost of money if they plan to borrow to finance a capital project, these calculations are very important. What they accomplish is to portray the real cost of capital and the real potential costs of delaying decisions. In the case of the $10,000 computer, the reality is that it will have to be replaced eventually and that more money will have to be spent to replace it in the future, taking into account its present value. Overhanging all of this is the question of the availability of funds and the relative priority this purchase may have. Generally, an organization would have to decide if it believes the increased cost to replace the computer in the future will be more or less than $13,382.26, and accordingly, whether to replace it now or later. These calculations alone do not give a complete picture of capital-planning issues for government.

Using Present Value Calculations to Compare Options

The following example outlines the application of present value to the cost of two office accommodation options.

Figure 6.10
Present Value Application to Determine Annual Cost of Two Office Accommodation Options

Situation: Environmental Services of Fordville needs to have new offices. Two options exist:

- Renovate and operate, in the current location, land owned by the town and not intended for sale as it is designated for future park use if the building is ever torn down. Given the age of the building, operating costs will remain high.
- Build a new building on town-owned land that is valued at $250,000.

Cost Assumptions

- Renovation costs are $400,000. Land costs in this instance are 0.
- New building costs are $650,000. Land costs are to be factored in as the land is available for sale.
- Additional maintenance costs for the renovated building, compared with the maintenance costs estimated for the new building, are $15,000 per year.
- Both options can be completed in one year.
- Life cycle of the renovated building would be 18 years. For the new building, the life cycle is 25 years.
- Discount rate is 5 percent.

Review of Alternatives

Renovate Existing Facility		**New Building**	
Capital Costs	400,000	Capital Costs	650,000
		Land	250,000
Total	400,000		900,000
5% discount rate for 18 years	0.0855	5% discount rate for 25 years	0.0710
Annual cost in present value	34,200	Annual cost in present value	63,900
Additional operating costs	15,000		
Full Annual Cost in present value	**49,200**	**Full Annual Cost in present value**	**63,900**

These numbers clearly suggest the renovation option, even with increased operating costs, is the better one. However, several factors need to be brought into the picture:

- Is this really an apples-to-apples comparison in terms of the quality of the accommodations as well as the fit to need?
- Is there a policy or political desire to expand the park adjacent to the existing building by tearing down the building that can be renovated?
- Are there additional benefits that a new building might bring such as easier client access or the potential for shared facility use with other departments?

Such factors will be called externalities by some, but are very real in the world of public administration.

The Government of Ontario's *Infrastructure Planning, Financing and Procurement Framework* strongly encourages the use of such concepts as TVM in infrastructure or capital planning, but it sets the use of such tools in a broader public-policy context:

> The evaluation process must include a value-for-money assessment of the options. In the broadest sense, the option providing the best value for money is the one that uses the fewest resources to achieve desired service outcomes. Relative value is determined through a rigorous examination of service delivery options and business-case analysis, considering a broad range of factors including service levels; cost; promotion of growth and employment; environmental considerations; and other health, safety and economic issues.
>
> With the introduction of accrual-based accounting for the province's finances, accounting considerations are no longer a driver of the model to be used for delivering infrastructure investments. The choice of model must be driven by economic considerations such as the efficient allocation of construction; financial and technical risks; effective project management; accountability; and financial discipline.
>
> A value-for-money assessment must consider the quantitative factors to which a dollar value can be assigned, such as initial capital costs, operating and maintenance costs over the life of an initiative (adjusted for risks), and ongoing operating costs related to service delivery (including energy costs).
>
> Quantitative factors also include those that can be quantified but are difficult to accurately translate into monetary terms. Examples may include the number of indirect jobs created by an initiative, the potential for broader economic stimulus, the level of measurable environmental benefits or the number of people served within a given timeframe.[5]

Using Net Present Value to Evaluate Investment Decisions

The acquisition of a capital item may set in place a cost flow for staff, maintenance, and upkeep that will add considerably to the net present cost of the decision that is about to be made. Net present value (NPV) is the future stream of benefits and costs converted into equivalent values today. NPV is a way of calculating whether the public-sector organization will be better or worse off if it makes a capital investment. It does so by subtracting the present value of outflows from the present value of inflows:

NPV = PV Inflows – PV Outflows

As you can see, calculating present value may involve receipts as well as expenditures. For example, the alternatives may have some salvage value after their useful life has ended. The estimated receipt, discounted to present dollars, from the sale of the item must be incorporated into your analysis as a PV inflow. The difference between the present value of the receipts and the present value of the expenditures (PV outflows) is net present value. The best financial choice is the option with the highest net present value. NPV is not necessarily a measure of profit or economic viability of a project. Rather, it is a measure of the net value of the project, captured, as best it can, as a monetary value. Projects with a positive NPV are considered cost effective, while those with a negative NPV are generally not.

The major factors affecting NPV are the timing of the expenditure and the discount rate. The higher the discount rate, the lower the present value of expenditure at a specified time in the future. Using NPV analysis to aid decision making in capital budgeting, the following factors are key:

- All cash flows, both outflows and returns (if there are any), must be included.
- TVM has to be a consideration and must be factored in because it will affect the value of the flows.
- Risk must be factored in, either quantitatively or qualitatively.
- Some method of ranking competing projects has to be established and aided by these forms of calculation, despite the complex and often subtle world of political trade-offs, compromises, and balanced considerations.

Net present value is a component of cost benefit analysis. It can be used as a criterion for deciding whether a government program can be justified on economic terms, which we realize is only one factor.

Cost Benefit Analysis

Cost benefit analysis (CBA) is a basic and important tool not just for capital projects, but also for many other forms of financial decision making. At its heart it is a calculation, sometimes made intuitively, many times formally, adhering to prescribed formats, especially for organizations with many decisions to make and the need to use common tools

5. See http://www.pir.gov.on.ca/userfiles/page_attachments/Library/4/IPFP_Complete.pdf?N_ID=4

for comparing the options that are available to them. A business case presents many of the elements of a CBA or may well be a CBA in all but form. It would come as no surprise, however, to note that CBA in government does not simply involve the application of tools such as NPV, but have to take into account the public purpose, broad public-sector criteria as well as sustainability issues. It is therefore broader, more complex, but potentially less clear than one that relies strictly on return on investment. Many of the benefits and costs are less direct and more difficult to measure in quantitative terms. Nonetheless, its applicability in capital planning is real for the public sector. Many factors, most notably alternative delivery options (make or buy) and alternative financial options (expense, borrow, PPPs) mean that tools such as CBA be applied to establish a relatively common base of comparison. Even then, challenges persist for CBA in the public sector. These will be addressed below.

The steps in creating a cost benefit analysis are:

- Establish full costing of the project, including construction, cost of land, equipment, etc. Project such costs over the life of the project and the life of the asset.
- Establish the life expectancy of the project, e.g., will the building be used for 40 years?
- Project the known operating costs (with contingency) over the life of the asset use, i.e., 40 years.
- Do the same for the status quo or alternate project that could achieve the same purpose, e.g., build or buy options.
- Discount cost flows to determine present value of costs.
- Define measurable benefits, e.g., fees or revenue. Discount over the life of the asset.

CBA is seldom as clear-cut as some decision makers would like. While the tools of determining NPV are indeed important, given the number of soft outcomes and inferred benefits accompanied by the real but vague concept of public good, analytical tools such as this have to accompanied by two conditioning elements. The first is that measurement in purely economic or quantitative terms is only part of the analysis. Softer benefits need to be taken into account, just as softer costs do. The second is that public administration works in a political environment in which factors well beyond the purview of such analytical tools are at play. For this reason, there is considerable interest in the notion of cost-effectiveness analysis, a form of modified CBA that incorporated as much of the quantitative analytical tools as possible, but also leaves room for consideration of the softer, less tangible factors. The key point here is that in capital planning and budgeting, every effort has to be found to develop analytical tools to permit good cost and benefit comparison and apply them in a consistent fashion in making choices.

It is equally important to realize that CBA is vulnerable to manipulation and gaming to get the desired result. Here are some of the tricks used to get the CBA the project advocate wants:

- **Chain-reaction game**: Include secondary benefits to make a proposal appear more favorable, without also including the secondary costs.
- **Labour game**: Wages are viewed as benefits rather than costs of the project, emphasizing the employment benefits to a region, for instance.
- **Double counting game**: Benefits are erroneously counted twice.
- **Phony quantification**: Create numbers that have no basis in actual project or program delivery, e.g., non-standard financial ratios.
- **Certainty in the face of uncertainty game**: This is a variant on the optimism bias.

Sensitivity Analysis

Sensitivity analysis examines the impacts on plans and cost projections of changing assumptions and ground rules built into those plans. Sensitivity analysis helps decision makers choose the alternative that reduces the potential negative impacts or risks. For example, it could allow a program manager to determine how sensitive a program is to changes in gasoline prices and at what gasoline price a program alternative is no longer attractive. By using information from a sensitivity analysis, a program manager can take certain risk mitigation steps, such as assigning someone to monitor gasoline price changes, deploying more vehicles with smaller payloads, or decreasing the number of patrols.

Sensitivity analysis involves recalculating the cost estimate with different quantitative values for selected input values in order to compare the results with the original estimate. If a small change in the value of a cost element's parameter or assumption yields a large change in the overall cost estimate, the results are considered sensitive to that parameter or assumption. Therefore, a sensitivity analysis can provide helpful information for the program manager because it highlights elements that are cost sensitive. In this way, sensitivity analysis can be useful for identifying areas where more design research could result in less

production cost or where increased performance could be implemented without substantially increasing cost. This type of analysis is typically called a what-if analysis and is often used for optimizing cost estimate parameters.

Some factors that are often varied in a sensitivity analysis are:

- A shorter or longer life cycle for the asset
- The volume, mix, or pattern of workload
- Potential design, safety, quality of material requirements changes
- Configuration changes in hardware, software, or facilities
- Alternative assumptions about program operations, implementation strategy, inflation rate, technology heritage savings, and development time
- Higher or lower learning curves, training requirements and skill sets
- Changes in critical performance characteristics
- Testing requirements in moving from prototype to service delivery
- Acquisition strategy, whether multiyear procurement, outsourcing, buy or lease
- Labour costs and rates
- Rescoping of the project.[6]

A sensitivity analysis addresses some of the estimating uncertainty by testing discrete cases of assumptions and other factors that could change. By examining each assumption or factor independently, while holding all others constant, the cost estimator can evaluate the results to determine which assumptions or factors most influence the estimate. A sensitivity analysis also requires estimating the high and low uncertainty ranges for significant cost driver input factors. To determine what the key cost drivers are, a cost estimator needs to determine the percentage of total cost that each cost element represents. The major contributing variables within the highest percentage cost elements are the key cost drivers that should be varied in a sensitivity analysis.

A sensitivity analysis typically has the following elements:

1. Identify key cost drivers, ground rules, and assumptions for sensitivity testing.
2. Re-estimate the total cost by choosing one of these cost drivers to vary between two set amounts, for example, maximum and minimum or performance thresholds.
3. Develop a comparative report based on the most significant set of differences, focusing on major cost fluctuations, major risk elements and flaws in the original set of cost drivers, ground rules and assumptions.
4. Evaluate the results to determine which drivers affect the cost estimate most.

Summing Up

While not all public-sector governments or organizations actually use separate capital budgets, they will, depending on their mission and scope of activity, always be concerned with the capital assets, their acquisition, maintenance and replacement. The conceptual tools and planning processes suggested here are important aspects of organizational financial management wherever capital plays an important role in carrying out that organization's mission. Thinking about capital challenges the line manager to look at the implications of such elements as the actual cost of an investment in capital for both operating costs and further capital investments.

One of the other important reasons to have a special awareness of capital budgets and how capital behaves over time is that in government, the issue of maintenance and replacement of capital goods often is easily deferred when difficult budget cuts have to be made. What this has led to in Canada is a serious underinvestment in infrastructure that will now cost much more, in present-value terms, to replace. This has been the victory of the short term over the long term. Unseen sewers very seldom attract political attention – until they break down. It has created a massive infrastructure gap around the world.

Accrual accounting and budgeting make it much harder to ignore the total costs and value of assets and their depreciation. In fact, virtually all Canadian governments capitalize their assets on their statements of financial position. It is difficult, if not impossible, to apply depreciation to assets that are held for historical or aesthetic reasons well past any accountant's notion of depreciation, but the vast bulk of public-sector assets do depreciate in a normal fashion. Past failures to recognize this show hopeful signs of disappearing. This positive trend will certainly require a better understanding of capital assets.

6. Government Accounting Office, United States, *Cost Estimate and Assessment Guide,* 2008.

Chapter 7
Taking It Back: Reallocation and Budget Cutting

Learning Objectives:

- Integrating the need for budget reviews tools in reducing, reallocating and readjusting budgets
- Understanding the dynamic nature of budget allocation and reallocation at the budgetary and in-year management control level
- Learning techniques of budgetary reduction
- Learning techniques on in-year resource allocation to meet emerging needs and achieve maximum budget efficiency

Budgets Don't Just Grow – They Shrink, Take on More Work, and Need to Adapt

Public administrators and politicians are often portrayed as budget maximizers – the more the better. Program advocacy within government and on behalf of it often leads to that one solution: more money. In reality, when looking at budgeting at the governmental or organizational level, the reality is quite different. As governments become increasingly concerned with their country's overall debt load and the cost of government, means to reduce existing budgets are being tried and applied around the world. Similarly, policy priorities shift. When that happens, budgets can also shift. What we have seen in the past decade, and can expect to see for some time, is a combination of variables that will inevitably lead to budget reductions in some areas with growth in others. The key variables are a commitment not to increase the overall government budget combined with prioritization for spending in certain areas. The best example has been the challenge to provinces to contain healthcare cost growth while restraining or reducing growth in other government services. This has led to an effective reallocation of the overall budget. When this happens, some have to find ways to reduce their spending. As this text is focused on financial management and not fiscal policy, taxes and the option to increase them will not be fully addressed.

Similarly, governments around the world are looking for ways to achieve expenditure rationalization within their existing budgets. The array of programs that governments offer is often dizzying and each has an advocate, good public purpose or historical presence. As pressure builds, however, governments have to look at questions such as whether a program really should continue, can it be offered in a more efficient and economic way, should governments even be doing this any more, and what can be done within the program to reduce costs. Such questions often translate themselves into such catchphrases as "doing more with less" or "lean management" or "rightsizing." This list goes on. The experience of some governments in systemic reviews is instructive and useful to understand.

At both the budgetary and program delivery levels, new options exist for delivering public goods, often involving forms of private sector engagement or arm's-length public entities with greater independence from central government controls. Part of the budget reallocation process involves sorting out – and costing in a complete way – such alternatives. It also entails reassigning resources from the traditional departmental model of government to this more complex world.

The other side of this examination is how public organizations effectively use the funds that they have in the

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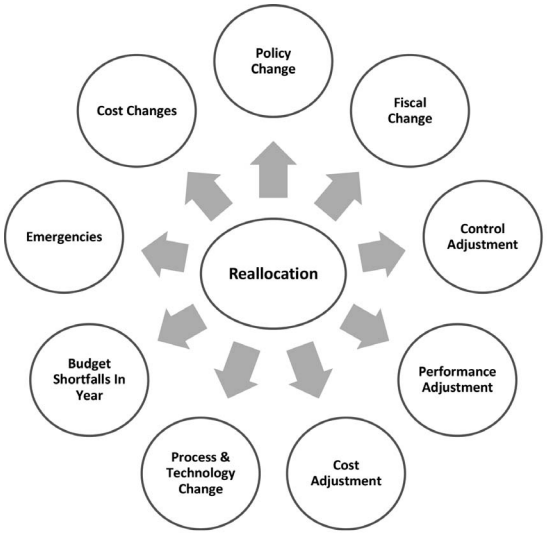
course of a budget year. Their capacity to effectively manage their funds means that they must, and generally do, have considerable flexibility to reallocate funds to meet emergency situations, unanticipated shortfalls or move surpluses to areas of needs. All of this takes place within the approved budget and the delegations the departmental management has to do this. This is an important part of good financial control in any organization. Chapter 9 in Section 3, **In-Year Budget Management** will address many of the techniques for doing this.

Figure 7.1, Drivers of Reallocation, summarizes the points that have been made above. The first two can be seen as variable, adapting to changing external circumstances, policy shifts and politics. The last four are continual processes in both budgeting and in-year budget management. Generally, they are an internal process, driven by the need to adjust to circumstances that do not neatly comply with plans.

Figure 7.1
Drivers of Reallocation



Most Budgeting is Still Incremental

The notions of reallocation and budget cutting seem to contradict the concept of incremental budgeting that has been prevalent in the public budgeting process for many decades. To a degree it does, and that is a healthy thing. Budgeting does involve a significant degree of incrementalism, with some estimates that 90 percent of budget line items remain the same with a possible addition of information from one year to the next, and budget management often does entail strategies to guard what you have. As governments face greater fiscal stress, they have begun to build tools to more effectively achieve their objectives of either greater efficiency in resource use or straightforward reduction in the size of government. Similarly, as public managers have learned that their funds are limited and subject to fluctuations, combined with a seeming endless array of demands within their established program mandate, they look for ways to squeeze every bit of use from the funds they have. They look as well for ways to find funds for emerging priorities without seeking more funds from outside their unit or organization.

Decremental Budgeting

The phrase decremental budgeting[1], taken here from Robert Behn's 1985 article, **Cutback Budgeting,** is not new. Governments have struggled with how best to cut budgets since they had budgets. Cutting budgets is no fun. Someone loses and, in both political and bureaucratic terms, that means some misery will be incurred. It is much easier to add than it is to subtract. As already observed in this section, the incremental budgetary process appears to be rational, albeit with a few added elements of a bar room brawl as final decisions are made. Cutting is often presented as irrational, reactive and reactionary. That is why some governments, as we shall see, have developed more institutionalized means to review existing budget commitments to free up resources. Results have been promising, but mixed, to date.

Reducing budgets and whatever processes are used have some characteristics that are quite different from the notion of incremental budgeting. Before looking at the techniques that are often used, it would be useful to understand how different the context of budgetary cutbacks can be:

- Historically, budget reductions, especially at the global level, are not routine.
- Cutbacks are often linked to deficit reduction, a universal problem but one that has little appeal at the personal level.
- Conflict – on many fronts – is inherent in the process of budget reduction, whether it is across the board or at a specific program level.
- There are winners and losers, often with loud voices.

1. This term is hardly new, attesting, to some degree, to the fact that governments have long struggled with how to cut. The phrase gained prominence in the following article: Robert D. Behn, "Cutback Budgeting," *Journal of Policy Analysis and Management* (pre-1986) 4, no. 2 (Winter 1985).

- There is nothing automatic about these processes. They must be driven by political and organizational will, often using up political capital in the process.

Robert Behn, in a recent newsletter ably summarized the different worlds of incremental and decremental budgeting, which is outlined in Figure 7.2.

Figure 7.2
Comparing Incremental and Decremental Budgeting

Comparing Incremental and Decremental Budgeting	
Incremental Budgeting…	Decremental Budgeting…
Generally decentralized to individual units, but might also involve incremental cost increases for common products, services and goods.	Normally centrally mandated and driven, except when across-the-board cuts require individual budget managers or departments to take decrease action.
Permits decisions to be made in a fragmented way.	Requires all substantive decisions to be put into a comprehensive package.
Focuses only on the increment while leave base program, funding and cost assumptions constant.	Forces a re-examination of the entire budget set of assumptions or the desirability of the program at all.
Is routine and consensual.	Is generally seen as episodic and extraordinary and potentially conflict-ridden.
Involves negotiations and accommodation, based on a stable set of relationships.	Requires confrontation and coercion, and can generate conflict.
Can be delegated to functional specialists and program managers and is mostly invisible.	Requires political and/or senior bureaucratic engagement and is very visible.
Appears to be merely distributive of resources within a known framework and sharing.	Is clearly redistributive and creates either a new framework or a transitional one with many unknowns.
Is historical, annual, repetitive, and predictable.	Is precedent-breaking, multi-year, erratic, and unpredictable.
Is rewarding (for there is credit to be shared), creates stable coalitions, and is seen enabling stability.	Is painful (for there is only pain to be absorbed), involves unstable coalitions, and thus requires active leadership.

Source: Behn, Robert, Performance Leadership Report, Vol. 10., No.12, August 2013. See www.ksg.harvard.edu/TheBehnReport as modified by the author of this text.

Continuous Reallocation: In-Year Budget Management

This is the yin to the budget reallocation yang. As **Figure 7.1** points out, there are many reasons for reallocation, some of which will permanently affect budgets for the coming years. However, moving funds with authorized allocations in a single budget year to meet emergent short-term needs is an important part of the reallocation process. So, too, is finding funds internally to meet new priorities and needs that can be, or have to be, accommodated within current budget levels. Often surges in demand, sudden requirements created by new laws, collective bargaining or other rule changes or just poor management mean that one part of the organization is in need of a rescue, a temporary funding of what is expected to be a temporary anomaly. Prior to departments going to externally available emergency or contingency funds, they must do their best to meet these needs internally. The obverse of this circumstance is what to do with unanticipated surpluses. Government organizations will always be looking for ways to fund initiatives that are within their mandate and within their authority to act on, provided they can find the funds. Similarly, internal improvements, even those that will ultimately yield savings for the organization, may require an internal allocation from within an existing budget.

A key difference between decremental budgeting and reallocation in-year budget management, even though they involve forms of reallocation, is that most budgeting decisions are multi-year and permanent, while in-year decisions are meant to be just that, in-year. They are intended to address short-term demands but not, at least at first blush, to have an impact on longer-term budgeting issues.

This area of financial management is a constant preoccupation of the public-sector manager. What follows should be read in the context of **Section 3: Achieving Your Objectives: In-Year Budget Management** with **Chapter 8, Managerial Control** and **Chapter 10, Cash Management: In-Year Budget Management and Monitoring**.

General Approaches to Reduce Spending

Whether the reduction is permanent or temporary, governments have a number of means to bring them to effect. This section will consider the broader tools that are available. Subsequently, we will look at what resources can be reduced or changed and some of the implications in each case. Finally, we will look at reallocation tools as part of the reduction and cash management efforts that are ongoing in most organizations.

In general, governments are pursuing a mix of five strategies to achieve budget reductions. These are:

1. Across-the-board cuts
2. Spending reviews
3. Efficiency gains
4. Outsourcing and privatization, and
5. Technology-based solutions.

We will look at each in turn. They seldom occur in isolation. Governments will mix and match depending on the urgency of the situation and the availability of opportunities. An across-the-board approach takes less time to bring into effect than a strategic review. Efficiency gains can only be realized if there is an alternative approach developed. Privatization will only occur if there is a willing buyer.

Across-the-Board Cuts

Across-the-board cuts are budget reductions that apply to all budgets in a more or less equal way. They can take the form of a percentage budget cut to the total budget or cuts to budget categories, e.g., a 4 percent reduction in all equipment budgets or a 25 percent reduction in travel. The key feature is that it applies to all such areas within the government's budget. Given the number of criticisms of across-the-board cuts, it is interesting to note how frequently governments use them when confronted with the need to reduce expenditures. Tom Peters, a notable management guru has wryly noted, *"Making across-the-board cuts is like going to the bank and asking for five inches of money."*[2] A recent example, dramatic in scope, of across-the-board cuts is the 2013 budget sequestration legislation in the United States. This practice imposed dollar reductions on a range of programs, with some exclusions. Congress did not direct what was to be cut, just the amount. For instance, Medicare spending was to be reduced by a fixed 2 percent per year over the next ten years.

In some respects, this form of budget decrement is the easiest, seen from the perspective of the decision maker. Some even argue that it is fairest as it affects all programs in the same way. The fallacies in that argument are threefold. First, cutting evenly fails to reflect program priorities. A cut in one area may affect many people while an equal cut in another area may not be as important or have such a great impact. Second, even distribution of decrements also assumes that the capacity to absorb or manage these decreases is the same. Some parts of government are better off than others. Some organizations can absorb the cuts. Third, this form of budget reduction effectively delegates much of the final decision making to individual units within the government organization being reduced. This will depend on the degree of flexibility that is permitted. However, some organizations may choose the route of reducing client service, while others may simply delay the replacement of infrastructure costs. In each case, the effects of these is unknown. This can lead to unintended consequences or, in the case of infrastructure, future costs and risks.

There remain good reasons for taking the approach. The first is that it is fast, at least from the perspective of making the decision and making the announcements. Rolling out the decision is another matter. That can certainly take time. The second is that it does distribute the burden of the reductions across the entire government or organization. Some perceive this as fair, even with the distortions in priorities and capacities that have already been noted. The third is that it does leave managers to sort out the best way to make the reduction. This flexibility permits them to be more creative in finding a solution. As well, governments will want to see if such reductions can be absorbed without an actual impact on programs. This hope is built upon the notion that there is slack in the system. Some call it waste. Some call it an opportunity to improve. Often across-the-board cuts will involve proposals for rule changes, regulatory and policy changes, or efficiency gains to enable organizations to absorb the reduction.

One concern about this form of reduction is that, due to the reasons cited above, it has been popular for some time. It has seldom been used just once but has been a key remedy over several decades in governments. Therefore, it eats away at program capacity over time and in an insidious way. This has been notable in the under-spending on infrastructure renewal. Often, it leaves organizations stripped of all redundancies, a dangerous situation for many public organizations that have to respond to dramatic changes such as emergencies, weather disasters, power failures, etc., but find that they have little spare capacity.

For the individual financial manager in government, the call to cut, yet again, another x percent from travel or training or core staff costs, becomes a reactive crisis. Across-the-board is a top down, often urgency-driven event. While the budget cycle may often prove such a reduction target is necessary in that budget, or directions for the coming year may require such a reduction, for the most part, these announcements are less planned than that. The manager has to respond, trying to maintain program integrity. It means that she has to have a good understanding of her budget and the capacity for reduction within it.

2. See http://www.tompeters.com/dispatches/010836.php

Spending Reviews

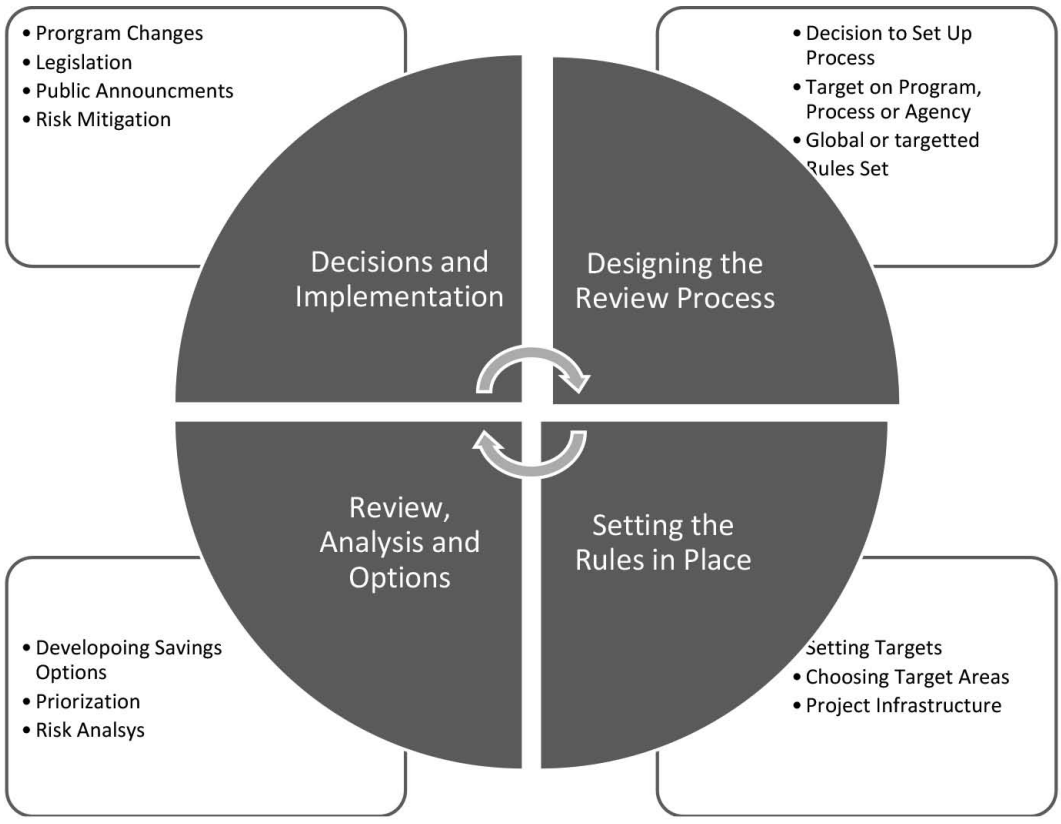
Spending reviews provide a more targeted and institutionalized approach to finding ways to reduce or reallocate budgets. A spending review is the process of identifying, reviewing and implementing budgetary savings, based on a systematic examination of baseline expenditures, business processes and program level commitments. They can be a useful tool in managing budget deficit pressures and in finding funds within existing budgets for new priorities. As Marc Robinson points out, "Properly viewed, it is a core instrument for ensuring good expenditure prioritization – more specifically, for expanding the fiscal space available for priority new spending in a context of firm aggregate expenditure restraint. "[3] Canada, Australia, the United Kingdom and the Netherlands have led the way with a variety of approaches to spending reviews.

The objectives of a spending review process are to identify savings or make funds available for budget reduction or reallocation in a way that examines individual programs to see if they can be eliminated, reformed, reduced or changed to yield the desired savings. Spending reviews can focus on efficiencies, i.e., how to improve processes and eliminate waste to reduce costs or strategic goals, i.e., program viability, program entitlements or changes to transfer payments. Usually these reviews are centrally driven by the Treasury Board or Ministry of Finance of the government. There will normally be a set of targets, a set of guiding principles for the review process, a central oversight provided either by politicians or by senior bureaucrats. Operating with a reduction target, departments are often asked to produce a plan based on the identification of their lowest priority programs or, alternatively, propose policy or delivery changes that will yield savings. The overall process is shown in Figure 7.3.

As an example of a comprehensive spending review, in 2006, the Canadian government launched an annual

3. Marc Robinson, *Spending Reviews,* OECD Journal of Budgeting, vol. 2013/2.

Figure 7.3
The Savings Review Process



strategic review process. All direct program spending was reviewed on a cyclical basis. Each year, 25 percent of government spending was reviewed. The government provided a set of terms of reference for the review:

- **Comprehensiveness** – assessment of mandate, departmental objectives, program effectiveness, efficiency and alignment to government priorities
- **Reallocation proposals** – options for program reductions or eliminations to reallocate to government priorities and support overall spending control
- **Reinvestment proposals** – options to better support government priorities.

Departments were to review the relevance and performance of their spending. They were to identify the lowest performing or lowest priority 5 percent of their programs, seek outside expert advice and report to the Treasury Board.

Departmental spending reviews were to answer specific questions in key areas:

- **Strategic**: government priority, federal role, relevance (i.e., continued program needs)
- **Efficiency**: performance (effectiveness, efficiency, value for money) and
- **Effectiveness**: management performance.

Departmental strategic reviews to be conducted using the following key elements:

- **Analytical framework**: The department's program activity architecture
- **Information sources**: Evaluations, audits, management accountability framework assessments, auditor general reports, and other reports
- **Reporting requirements**: Outlined in the terms of reference
- **Steering committee**: A departmental steering committee to be established with ex officio membership from Treasury Board staff
- **External advice:** Expert outside advice to be involved on each review to ensure neutrality and credibility.

As can be seen, this is a considerable amount of work, bordering on a form of zero-based budgeting (ZBB). However, it did produce results, if the targeted result of reduced government spending is the objective. For example, in 2009, twenty federal departments undertook strategic reviews of 100 percent of their total direct program spending. In total, almost $26 billion, or 23 percent of all government spending was examined. A savings of $287 million was approved. These savings were redirected by the government to eliminating a program or to other priority areas, including deficit reduction.

Reviews of this kind have proven successful, but only when the process is well formulated, managed with discipline and there is a clear sense of the desired monetary result. Some of the downfalls are that such reviews inevitably lead to political controversy as programs are closed or reduced. Rather than appearing, as across-the-board approaches do, to apply to all, strategic spending reviews can have the opposite effect: interest or advocacy groups feel singled out (which they are) and criticize the government accordingly.

Spending reviews need discipline and long-term commitment, qualities often lacking in electoral cycle driven governments. Further, bureaucratic resistance to the amount of work required and to the limited results in some cases often diminished sustained commitment.

Spending reviews involve the individual financial manager in many ways. As an area under review, the manager will have to provide information on the programs, their performance and input to changes that might be made. For this, he will have to draw on multiple sources of evidence such as evaluations, audits, benchmarking and international comparisons. Similarly, he will have to demonstrate that his program is strategically aligned with the government's direction. He will have to offer up alternative means of delivery. He can also suggest ways to save money and improve the program, such as efficiency gains, which will be discussed in a moment. Should decisions be made to reduce or eliminate a program, the manager then becomes engaged in change management as well as winding down the program. Managing budget reductions or any kind of change to achieve savings is an important part of leadership. As Schmidt, Groenveld and Van de Walle point out, "Managers can be positioned at the intersection of various imperatives, both externally and internally, such as their political leaders and their own subordinates. All these actors place different demands on public managers and may try to influence the decision-making process towards their own preferences or, at the very least, are actors that need to be considered when managing cutbacks."[4]

4. E. Schmidt, S. Groweneveld, and S. Van de Walle, "A Change Management Perspective on Public Sector Cutback Management: Towards a Framework for Analysis*," Public Management Review*, 19 (10), 1538–1555. See https://doi.org/10.1080/14719037.2017.1296488

Efficiency Gains

"Efficiency measures are funding reductions realized from minor or major changes in the way existing programs are delivered. The objective is to deliver the same program outputs and outcomes with fewer inputs (resources)."[5] The mantra of making government more efficient will always be with us, even after centuries of making government more efficient. However, governments continue to try to find ways to reduce costs through better practices, to find cheaper means of delivery and to reduce waste and duplication. Sagas of failure abound. However, there have been many successes as well. As a form of budget reduction, it remains important. Further, the field is still fertile.

Efficiency gains take a number of forms:

- Integrating points of service to the public among departments to reduce the number of offices and share services in each office
- Amalgamating support or back-office functions into centralized shared service units
- Replacing people (a high cost component of the budget) with automated systems (theoretically less expensive)
- Replacing higher-paid staff with lower-paid staff who would carry out some of the functions of the more expert staff, e.g., administrative duties associated with casework follow-up, enabling the caseworker to carry a larger caseload
- Modernizing delivery systems and information systems to identify costs and control them better – this is different than using automated delivery systems in that it is intended to enhance internal management
- Increasing delegated authorities and reducing the number of decision-making levels to speed up processing
- Reducing office hours
- Reducing travel costs through the increased use of videoconferencing
- Outsourcing elements of program delivery, or of support systems to lower cost, often to private sector providers
- Changing processing rules, regulations and eligibilities to reduce the number of people eligible or the time needed for review
- Strategic procurement which would standardize purchasing specifications, limit vendors to increase volume, and buy as a single unit and even with other government units to drive cost reduction in purchasing major items.

The first test of changes like this is whether they actually achieve the budget reduction targeted. For the most part, any savings are longer term, as some form of investment is usually needed to achieve them. This may take the form of investment in new technology. This takes time to implement and, with large risk projects, costs may increase, which reduces the attractiveness of the original business case. Often, as well, this means making capital investments to reduce operating costs. Lining up the two processes becomes key.

Efficiency gains drive at the heart of the productivity element of government. It also is another means of avoiding so-called arbitrary across-the-board cuts. However, unlike the strategic review, they will involve some form of investment, reconstructing the old cliché, "You have to spend money to save money." Of course, spending reviews, discussed below, can point to efficiency gains as a means of reducing government costs. In that sense, the two can go hand in hand.

Outsourcing and Privatization

Reference has already been made to possible outsourcing for efficiency gains. In terms of permanent budget reduction, some definitions are in order. Privatization means that the government divests itself of the ownership of an asset or program and leaves its operation to the private sector. It can do this in a number of ways. As in the case of many national airlines, it can sell the operation outright. It gains the capital from such a sale but loses the income (or operating loss) stream forever. The asset leaves the balance sheet of the government. The net effect is a reduction in the size of government as well as a lower overall budget figure. Governments may retain a strong public policy interest in, for instance, airline safety and competition. However, they are not owners or operators of airlines. They exercise that interest through other means such as legislation, regulation and the creation of oversight bodies.

Outsourcing simply means to buy goods or services that have been carried out by government staff from an outside of government supplier on a contractual basis. Gilley and Rasheed[6] point out that outsourcing is the procurement of

5. Canadian Parliamentary Budget Office, *Budget and Expenditure Reporting to Parliament: Strengthening Transparency and Oversight in an Era of Fiscal Consolidation*, 25 April 2012. See www.parl.gc.ca/pbodpb/RedirectDocument.aspx?Url=/Macintosh%20HD/Users/AG/Downloads/Budget_and_Expenditure_Reporting_EN.pdf

6. K. Matthew Gilley and Abdul Rasheed, "Making More by Doing Less: An Analysis of Outsourcing and its Effects on

something that was either originally sourced internally or could have been sourced internally but the decision was made to go outside. Therefore, government remains in control of the funds used, the assets created and, ultimately, the quality of the service or good being provided. Outsourcing can take many forms and affect many services. In the context of this text, the objective of outsourcing is to reduce costs of a particular function. In essence, the function is purchased from a supplier. The test is whether, over time, the costs of the service and of managing that outsourced service are less. This is a challenge as governments use outsourcing for many reasons and these are often mixed in with issues of cost savings. For instance, government occasionally needs expertise that they do not normally use on regular enough basis to have in-house capacity, let along afford it. Hence, the use of consultants is a form of outsourcing.

Because outsourcing has developed a panacea-like quality, especially during the era of new public management (NPM), it is not without its detractors. Experience has shown that major efforts to outsource information technology have resulted in escalating costs and, in many cases, failed implementations. Critics will point out that there are considerable risks in outsourcing, ones that can, over time, lead to higher costs, thereby negating the budget reduction intent. Such risks are loss of control of the cost drivers, loss of internal competence in a core or near core area of activity and oversight failures that lead to corruption or the misuse of funds.[7]

Technology-Driven Solutions

Technology can be both the cause of cuts and a means of achieving them. Introducing new technologies to process operations may reduce the number of employees needed to do the work. Efficiencies are realized and costs can be reduced, at least on the staffing side. As organizations look at processes to find ways to change them, to reduce both work and increase speed of service, they face a challenge, one that governments and the private sector have mixed results with – investing in technology to save on staff costs means spending while the savings are sometimes not realized, the change is a disaster, or savings are only realized in future years.

Improving processes, speeding them up, improving quality and reducing client wait-time are commendable goals for any government. In fact, it is inherent in good management – a focus on effectiveness and efficiency. However, history abounds with stories of failed efforts to use technology to reduce costs when the very solution starts to cost more than planned, does not work as planned and is not delivered in that much-used but perfectly good phrase "on time and on budget." There is a rich literature on this topic.[8] There are pyramid-sized piles of government and consultant reports on projects that have failed. Unfortunately, there is less known about projects that have worked. As is always the case in the public sector, what works is silent and unnoticed. What doesn't work leads today's news ticker and gets more tweets.

That being noted as a cautionary tale, such efforts can potentially pay off, as long as they are well managed. The strategy seldom will produce net savings in the short run. Following the adage of "You have to spend money to save money" the strategy has to be grounded in good analysis of all costs and avoid the pitfalls of declaring savings before they are actually realized. Further, these changes require time to be implemented successfully. There will be new costs, often capital up front and the new operating costs along the line. Further, there will implementation and transitional costs. With respect to the former, this may entail the use of consultants, large systems firms and dedication of specialist teams within the organization. Sometimes these costs do not appear as new costs, but rather the shifting of duties of staff to this new project. This is a cost as the former duties of that staff are either not being carried out or have been shifted to others. A major failure in costing major technology shifts is calculating how much staff time and effort this will take.

After considering all the risks of new technology, it remains that this is a viable and useful option for reducing process costs and increasing services. Such changes can offer an organization real change with improved service at lower cost. The basic rule in using it is "eyes wide open." Survey after survey of major governmental technology implementation projects point to an 80 percent failure rate in terms of cost, time and productivity outcomes.[9]

The key sources of success in such projects are:

Firm Performance," *Journal of Management* 26, no. 4 (2000): 763–90.

7. C. Harland, L. Knight, R. Lamming, and H. Walker. 2005. "Outsourcing: Assessing the Risks and Benefits for Organizations, Sectors and Nations," *International Journal of Operations & Management* 25, no. 9, 831–850.

8. A. King, and I. Crewe. 2014. *The Blunders of our Governments.* London: Oneworld Publications.

9. McKinsey Centre for Government, Survey of Public-Sector Transformations, December, 2017. See https://www.mckinsey.com/industries/public-sector/our-insights/a-smarter-approach-to-cost-reduction-in-the-public-sector

- Adequate planning and timeframes
- Accurate costing – full life-cycle costing
- Consistent and persistent governance:
- Leadership – on board and remaining on board
- Project Management – having skills and consistency
- Effective risk management.

The key sources of failure are:

- Optimism and overconfidence in program costs, timing and outputs
- Poor costing and avoiding full life-cycle costing implications
- Making cuts (letting people go, shutting down legacy systems) before new technology is in place
- Failure to test systems
- Ignoring risks
- Constant change of leadership and project management.

General Approaches to Reallocation

Reallocation has two sides, reflecting the budget-based or in-year cash management base of analysis. From a budgetary perspective, reallocation involves a permanent movement of resources from one program or unit to another or its use to pay down debt or be otherwise totally removed from the budget. In-year reallocations generally take place within a department. They are for one year only and the funds are not permanently reallocated. The mechanisms of this process are addressed in **Chapter 9.**

The net effect of reallocation is not only to reduce the overall budget level. Rather, it can be to make priority adjustments in the budgetary allocation and to resolve temporary changes in demand or cash requirements for in-year management. However, in both instances, some decisions have to be made concerning the continuance of the existing program from which resources are extracted or moved. Further, some accommodations to permit the freeing up of those resources have to be made. It is to these that we now turn.

Strategies and Tools for Reduction and Reallocation

This chapter has already addressed some of the tools available to government personnel should they decide, through any of the broad techniques outlined above, to reduce or reallocate resources. This section will address specific areas of reduction. Each is contentious politically and risky in a number of ways. Even in the face of those risks, these measures have been used by many governments, with varying degrees of effectiveness, around the world. These strategies and tools are not mutually exclusive. In fact, they affect each other. For example, reducing staff in a client service operation will inevitably lead to service reductions, brave claims to the contrary notwithstanding. As well, the service and organizational impact such as morale, institutional memory, and contingent capacity to respond to emergencies are affected by any and all of these steps.

Service Level Changes

Governments can simply reduce the level of service it is providing to the public. Hours that an office is open can be reduced. Eligibilities can be changed. Access can be restricted. In each case, there has to be some reduction in staffing and use of other resources. Alternatively, government can reduce the number of inspections or audits where it operates in a regulatory mode. Finally, government can simply stop a service entirely.

Change the Employment Arrangements to Reduce Salaries

This strategy entails seeking major changes to collective bargaining arrangements that set employee salaries and benefits. It can also involve making such changes unilaterally for non-unionized staff such as the executive cadre. It can also entail changing the way in which pension schemes are funded. This has become an even more contentious issue for budgeting as full accrual accounting now requires that the pension liability of governments be fully reported on its books and integrated into its deficit calculations.

Reduce Staffing – Permanent and Temporary

The largest portion of most public-sector budgets is personnel. Staffing level reductions, whether through attrition or outright dismissal, is an essential part of any budgetary cutting scheme. It is also one of the most complex challenges. The public sector remains one of the most unionized parts of the economy. As well, the traditional public service has been designed around the notion of permanent employment. In addition, most governments have employment standards that dictate how employees are to be treated when their jobs are declared redundant. Therefore, there are transitional costs associated with staff reductions. If the government decides it has to move quickly, it will go the termination route. This will mean some form of severance cost may be involved. Similarly, the government may provide a transitional period in which the employee can seek another job within government. This means that

the savings are delayed. Should the government decide to reduce staffing through attrition, it imposes on itself a much longer process, as it awaits the departure of the employee through job change or retirement, thereby leaving a vacancy, which it then does not fill. Once again, savings are delayed.

For in-year budget control, staffing can be delayed. This is the freeze that new governments are so fond of imposing upon taking office to clean up the budget mess left by their predecessor government. The normal staffing delegations will be removed from managers and all staffing reviewed by a more senior person. Positions can be left vacant, thereby realizing a temporary salary saving. Temporary staffing can be used rather than full-time permanent staffing. This should be at a lower cost and also permit management to terminate without the processes outlined above.

Renegotiate Contracts

Governments depend heavily on procurement of goods and services to carry out their business. The scope and level of contracting varies across agencies, but some are very heavy users. Facing overall cutbacks, the agency has to review what it can do, either immediately or at a contract's renewal, to either decrease the contract's cost or gain additional service to displace what is being lost on the staff front. As in the efficiency gains discussion, managers can look to partnering with other agencies to share procurement to reduce costs by gaining leverage to reduce the bid cost and reduce the administration costs as well.

Defer or Cancel Investments

Investments include capital purchases, major systems changes, reclassifications of jobs and other major purchases. Governments can cancel major projects or choose not to invest in them to reduce their budgets on a permanent basis. They can defer maintenance (at some considerable risk) or lengthen the cycle to lower overall costs. Major purchases such as military equipment can be cancelled. In-year, governments or units of them can re-examine their commitments to see if maintenance and purchases can be deferred, thereby punting the cost into future years. Equipment replacement cycles can be lengthened so that vehicle and computers are replaced less frequently.

Ridden throughout these options are risks and hidden costs. Further, the late twentieth century saw governments doing just what was described in the above paragraph in bridge and road maintenance across North America. The tragic outcome of bridges collapsing is well documented. On the other hand, there is ample potential for savings in such practices as well. As in all of these options, the risks have to be acknowledged and managed.

Reduce or Eliminate Discretionary Spending

In addition to staff costs, there are budgetary elements that are frequent targets in reduction processes. Therefore, eliminating travel money or reducing the training budget are easy and frequent targets. Similarly, programs with funds that support voluntary organizations will reduce their support to these groups. Funds to support program-related research activities can be eliminated, as can funds to hire summer students. The list is long.

Amalgamate and Reorganize

This can take the form of bringing services offices together with a specific reduction in the number of staff and scope of service. Back office operations, generally administrative units that support program units through business functions such as finance, information technology and human resources, can be amalgamated or outsourced. The number of offices for a program can be reduced. Smaller offices in the area being served can be closed and a larger office designated to serve the same area. In each of these instances, there are transitional costs and potential service implications.

Increase Fees and User Costs

Even governments that steadfastly resist raising taxes will willingly permit user fees and charges for service to rise. These moves are unpopular but those affected are more isolated than broadly based tax increases. The effect on the Treasury is the same – more money. There are already many user fees built into the provision of government services, from park entry fees to road tolls to license fees. In addition, government can limit access to services that transfer the cost to the user. For example, listing a medication for free access by seniors increases costs to the government. De-listing it reduces those costs and transfers them to the patient.

Internal Transfers – Temporary and Permanent

Governments are complex entities. While the general view is that there is one budget, in reality, there are many. Departments of government have individual budgets. In turn, units within departments are assigned budgets from the departmental funds. In order to make this operate smoothly, reserves are created at various levels to permit

governments or their agencies to react to changing situations. Such contingency will vary with the government. In some cases, creating such reserves is legally mandated. In others, it is a matter of managerial practice. Facing pressures to meet gaps in either current spending or in budget planning, these reserves can be brought into play. Certainly, with respect to in-year budget management, having this kind of flexibility relieves the need to take some of the steps listed above. For a permanent move, the risks and consequences are greater in that the reserve is therefore lost forever and, with it, a certain amount of redundancy to meet emergent needs. That is a risk decision that must be considered. As well, if a government uses a reserve to meet a permanent or in-year need, it will have to replenish that reserve for the next shock.

In this complex environment, some units may overspend and some underspend. Therefore, agencies are expected generally to manage such overages and underages by internal reallocation, on a temporary basis, from one budget to another to cover off the problem. What has to also happen, as we will see in detail in **Chapter 9** is that it must also manage the situation that created the variance in the first place. This may well mean adjusting the program and its budget to accommodate what the agency identifies as a permanent change. It may also be a question of short-term anomalies, emergency situations that can be accommodated within the budget, or just poor management that will have to change.

Sell Off Assets

Governments own a lot of land, buildings, equipment and related assets known as nonfinancial assets. However, the scope is larger. It can include intellectual property, valuables such as precious metals, natural resources, contracts, even frequency bandwidth. In the latter case, many governments have made windfall profits in the sale of such bandwidth. Disposing of assets like these that are not mission centric, or that can be acquired differently, is a ready way to make some one-time cash gains. It seldom is relevant to the individual manager as large governments will dispose of these assets centrally.

Cutback Management

Whatever the mix of strategies and tools that are put in place, the management of cutbacks and reallocations is a major challenge for public administrators. As Moore, Baber and Bartlett said in an article in **Public Finance and Management,**

> Much of the politics that make budget cutting difficult have to do with resistance to disruptions in the supply of these [valued] sorts of public goods in the absence of which people must work harder, work longer or work in different ways to achieve their objectives.[10]

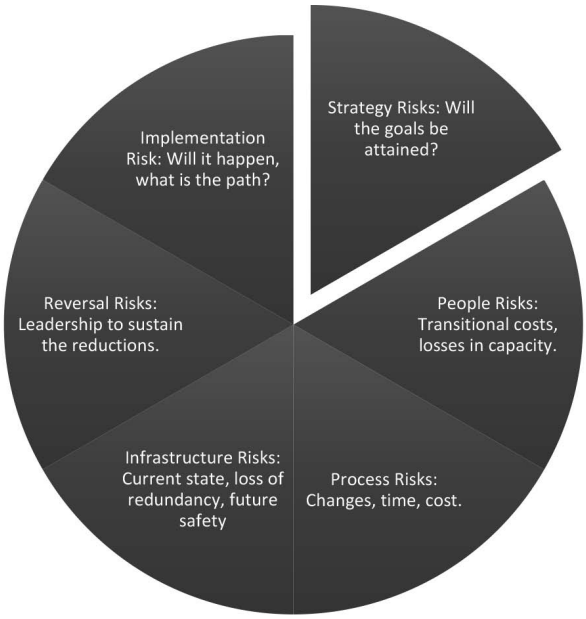
First, they are challenged to be ready for such changes. Any public manager who is not aware of budgetary pressures on government and the continuous need to find way to reduce costs is working in a rather comfortable parallel universe. These pressures are a constant in the life of government. Second, they are challenged to manage their resources, with adequate controls and monitoring, so that they can identify potential deficits or surpluses and deal with them. Third, they are challenged to respond, defend and clarify the nature of the cutbacks. They have to look to the sustainability and adaptability of their programs, making sure that all risks are understood, mitigated or accepted. They also have to find ways to adapt the program to its reduced circumstances. Finally, they are challenged to implement the cuts through whatever set of strategies have been chosen. These are all active roles that will now be examined in more detail.

Framing the Cutback: Risks and Consequences

The careful preparation of any budget change proposal is vital if it is to be successful in terms of program sustainability and also actually realizing the savings. Managers have to understand and advise on the risks inherent in the change. They also have to search for ways to mitigate such risks. For instance, the introduction of a new user fee can be spread out over a number of years, each year rising slightly, until the desired income level is reached. This reduces somewhat the risk of a user revolt. On the other hand, it increases the risk that the desired budget reduction will not be reached if the pressure against the fee increase results in a political decision to halt it. Further, there will be pressure from the central drivers of the budget reductions to achieve the savings as soon as possible. **Figure 7.4** points out some of the risk areas that have to be considered.

10. W. Moore, W. F. Baber, and R. V. Bartlett. 2012. "Loss Aversion and Rationality in Cutback Management," *Public Finance and Management* 12, no. 3, 237–260. See http://search.proquest.com/docview/1095379000?accountid=6180

Figure 7.4
Risk Framework for Cutback Management


Strategy Risks: Will the goals be attained?
People Risks: Transitional costs, losses in capacity.
Process Risks: Changes, time, cost.
Infrastructure Risks: Current state, loss of redundancy, future safety
Reversal Risks: Leadership to sustain the reductions.
Implementation Risk: Will it happen, what is the path?

Source: While this is a compendium of risks identified through a variety of research, part is taken from Canadian Parliamentary Budget Office, *Budget and Expenditure Reporting to Parliament: Strengthening Transparency and Oversight in an Era of Fiscal Consolidation*, 25 April 2012. See www.parl.gc.ca/pbodpb/RedirectDocument.aspx?Url=/Macintosh%20HD/Users/AG/Downloads/Budget_and_Expenditure_Reporting_EN.pdf

Knowing Where to Look: Control Brings Insight

Managers have to have adequate control of their budgets to not only deliver their programs but also to understand the pressures on the budget and the potential for variances from plans. That also equips them with a good understanding of the impact of a budget reduction or reallocation direction on their capacity to deliver. They will also understand where they can cut and how, often at a level of granularity more refined than those who are centrally located (be that in the Treasury or the Finance office of the agency) and lack specific knowledge about individual programs.

Implementing Cutbacks

The consequences for the public manager of cutbacks are extensive. They include:

- **Personnel:** The impact on personnel can be immediate or, worse still, a slow and lingering threat of job loss. The announcement of cuts has to be accompanied by effective communication within the working unit on the impacts and processes to be followed. Ambiguity creates serious performance and morale problems within the unit. Taking that into consideration, there are a number of short and long ways to reduce staff costs: slow down hires, keep positions vacant, announce outright layoffs, resist replacing staff who retire or leave, shift to less expensive contracted services or less costly short-term employment, modify working hours and work arrangements to cover peak periods. In undertaking any of these, consideration has to be given to the transitional costs such as possible retraining, severance and relocation. With respect to contracted services, full costing is essential, which includes contract management and transitional costs.
- **Programmatic:** Do the cuts represent a fundamental shift or loss of capacity to deliver the program as it is presently construed? If so, what has to change – the law, regulations, policies – to match the new resource state? The greatest danger in all of this is saying that nothing will change as a result of these cuts. Aside from being an odd way of saying that you had too much money, it may also be a lie.
- **Clients:** Should fees be raised, or savings made due to a reduction in personnel leading to reduced service components, clients will be concerned. As Joni Mitchel sang, "Don't it always seem to go that you don't know what you've got till it's gone?" Many public programs are highly valued and have broad client bases. While there are political consequences to be dealt with by politicians in such cuts, there are also programmatic ones.
- **Systems changes:** As noted, many cuts come in the form of cutting with policy, program or systems changes. The implementational and transitional elements of these have to be managed as the cuts occur.
- **Performance expectations:** Managers are caught in a dilemma when it comes to cutback management: how much and how long to resist or try to negotiate in defence of the program versus faithfully implementing the decisions once they are made. Bureaucracies are not without their guerrilla warriors. There is a tension here that is well recognized by agency leadership. That is why, generally, cutbacks take on a more centrally controlled element.
- **Sustainability risks:** Often cut-backs will mean that maintenance schedules are lengthened or eliminated

entirely. Training is often deferred or reduced to a minimum. Systems are not upgraded. Inspections are reduced leading some vital services, e.g., long-term care facilities or children's services, with less oversight. All these changes affect the sustainability of the program over the long term. Of course, many of these decisions, especially the non-strategic spending decisions, ignore this.

- **Hitting the target:** Calculating and agreeing on the baseline against which savings are measured has proven elusive for many governments. Some have had to go back and recalculate savings once they realized that the baseline was not correct. This is important for the manager, as she will be assessed in terms of performance against the target. However, if the baseline is accurate, reaching that target becomes more difficult. In addition, savings should be reported net of implementation costs.

Some Overview Comments for the Program Manager

Cutbacks, reallocation, looking for ways to use money more effectively and efficiently are a constant factor in public-sector financial management. Financial managers have to be ready to engage in these activities, whether they are imposed from above or outside or are part of their own needs to gain better control of their in-year budget, find flexibility to fund policy and service shifts, or improve operations in any number of ways. Therefore, they should, as they develop their internal control process, also develop their own process for identifying sources of possible reduction and reallocation. Getting there first puts them in a positive position to assess the impacts of resource reductions or shifts.

Being protective of one's resources is a good thing. Being stupid about being protective is another. Treating all suggestions for reallocation, modification or reduction with full flight guerrilla resistance will eventually put the individual manager on a career spiral driven by gravity not ascension but also leave the organizational unit vulnerable in terms of its adaptability and capacity to manage imposed change. The financial manager therefore has to be the one to ask the tough questions, such as:

- Is the activity designed to operate as efficiently as possible?
- Can we find partners within the agency to share costs?
- Have necessary materials been purchased at the lowest price while maintaining quality?
- Are we locked into contractual arrangements beyond our control?
- Can the process be mechanized or computerized to minimize staff costs?
- Can this be delivered through a third party more cheaply?
- Can processes be standardized within and across units to reduce costs?
- Can units be amalgamated?
- Can IT be better sourced?
- Can you look at fleet reductions or better management?
- Can you increase revenue?

Program managers need to know their cost structure. For instance, what is your costliest input? For much of government, it is people. Drill down. Is it regular salaries or is it overtime? How does your position classification system, which establishes salary levels, work in this regard? Do you have a top-heavy organization? Do you have a major sick leave issue and is it costing you? Compare and contrast. Find cost comparisons that help you determine if your processes cost more or less to operate than similar ones. This also enables a knowledge transfer that permits the manager to find places where other solutions have been tried and worked.

It pays to know the budgetary and financial performance history of the unit. What has already been done? Have all the low hanging fruit, i.e., the easy solutions, been plucked? On the policy and program side, the manager should be able to link reductions, permanent or temporary, to results. Will this change the results? Will this threaten promised delivery? If so, what can be done to reduce the impact?

Reductions seldom occur in a singular, one-off way. There are generally a series of reductions taking place in an agency at one time. Program managers should be sensitive to the impact of reductions in other parts of the organization that will affect them. This is most significant in staff functions, which often operate centrally, but provide services that are vital to operating units. For instance, changes in the level and service capacity in Human Resources, Finance, Information Technology or Procurement will affect many operational units. The manager cannot assume that this has been considered or thought through.

Cutbacks and reallocations may involve some give and take in order to bring them to effect. For example, a manager might be able to reduce staff requirements if certain additional flexibilities in making decisions and levels of inspection are provided. This would change operating

procedures, delegations, and authorities. These changes could also achieve greater program efficiency and effectiveness. As noted above, keep this process happening today in perspective: this will happen again. Often managers will be able to accommodate the reduction this time but put in markers about the decreased flexibility in the future. Managers can also seek transitional assistance and money to achieve the cuts. This may sound at odds with the overall objective, but it often does happen. For instance, if staff is affected in one unit, the manager may ask that staffing actions in certain other units be halted until the affected personnel are reviewed for suitability for those positions. Further, they may require some training to be eligible, a cost that the manager has to seek to be covered as a transitional one.

Above all, the financial manager, when faced with cuts or reallocation, should move with deliberate speed. As already noted, ambiguity is the greatest enemy of staff effectiveness and morale. As soon as the word is out that reductions are on the way, the first question each employee asks is, "What about me?" The manager may provide all the communication in the world about the process and give assurances about impact. Until that question is answered, it is all noise.

Section 3

Meeting Your Objectives: Controlling and Managing the In-Year Budget

Chapter 8
Managerial Control

Chapter Objectives:

- Understanding managerial control of finance and operations in the public sector
- Linking the idea of control to the achievement of program objectives
- Outlining the range of controls available to managers and organizations
- Reviewing the role of risk management in developing control systems
- Understanding the concept of government-wide controllership

Introduction: Control Is About Delivering

As this text has moved from public-sector budgetary processes toward effective use of the funds obtained within the legislative or organizational framework, its focus must, of necessity, turn to the effective management or execution of the budget. As noted, the budget is a plan. Now it has to be carried out. The desired outcome of implementing the budget is to achieve the objectives of the program, project, or line of activity in the most efficient and effective way that is reasonable in the situation but with an equal concern for the proper use of public funds. So, results for sure, but in the right way. This requires a series of controls to be put in place to make sure that the objectives are being met in the context that has just been outlined. Such controls extend beyond the more readily visible ones such as audits and external review. In fact, these comprise but one element of a full control framework. Control begins and ends within the management environment. Increasingly, internal control and new tools for risk management are merging into a single enterprise. This is why we briefly address risk and risk management in this chapter realizing the fuller treatment of risk in **Chapter 2, Risk and Accountably: Core Concepts.**

A control framework is the set of principles, values, practices, rules, procedures and policies that provide the agency, its governing body and external stakeholders with the assurance that it is operating in a way to achieve its objectives in the manner laid down in law and sound managerial practice. Control is what we do to see that things we want to happen will happen and things we do not want to happen will not take place. The objectives of the framework, as set out by COSO (Committee of Sponsoring Organizations of the Treadway Commission),[1] a global standard setter in this area, are:

- **Achieve operational objectives**: Do what you are there to do.
- **Provide financial and non-financial information** for internal and external monitoring: Is your information reliable and accurate?
- **Ensure compliance** with relevant policy, laws and procedural rules.

The COSO definition of control is that it is a "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations."

The control framework consists of five interrelated elements that pretty well describe how an organization should be run. They are:

- **Control environment:** Setting the tone for the organization, establishing and practicing core values

1. COSO Internal Control – Integrated Framework, December 2011. See www.coso.org/documents/coso_framework_body_v6.pdf

such as honesty, adaptability and encouragement to report variance
- **Valuing and managing risk:** Ensuring the organization has a healthy approach to risk and a method to manage the risks it takes and experiences
- **Control activities:** Having and practicing polices and procedures to address inherent risks to achieving objectives such as being on budget
- **Information and communication:** Implementing and using information systems, including financial, operation- and compliance-related data and analysis – this is the backbone of both effective risk management and control activities
- **Monitoring:** Ensuring that the control system and tools are working to give the organization the true and full picture it needs – this means reviewing systems, evaluating the effectiveness of controls and external inspection from time to time.

Figure 8.1, now a well-known one created by COSO, shows how these objectives and tools have to interact with each other and also within the structure of the organization for which the controls are needed.

Figure 8.1
COSO Control Framework

We have already looked at the face-side elements that apply to this framework. Note as well that they apply to the three main functions of managing the public enterprise: operations, reporting and compliance. Operations is the core set of activities of the organization that it exists to perform. In this context, that will mean a public-service or public-sector activity such as policy development. Reporting covers a range of activities, both internal and external, that provide the organizations and its stakeholders with the information they need to perform, control, oversee and assess performance. Compliance is an important public-sector function as this involves compliance with laws, regulations and policies that govern the work being performed, the financial and operational rules and a range of unique, public-sector requirements for equitable treatment, fairness and transparency. The final dimension in the cube simply reflects the reality that controls exist at many levels in the organization, not just at the top. As well, they can follow a hierarchical path, moving from the top leadership level to the operating units. However, they can also follow a functional path, one in which certain controls will be in place in one functional area, e.g., financial operations, no matter where they take place in the organization.

This chapter will explore ways that program managers, usually working with both operational and financial information, exercise effective control that they need to get the job done, stay on budget and adjust to changing realities and performance. It is not simply about following the rules. It is truly about being in control of the resources you have been given to achieve the goals of the program in the desired way. To do that, the manager has to have, and give, reasonable assurances in each of these areas. **Chapter 9: In-Year Budget Management** will explore the mechanics of an essential control function – staying on budget and adapting to change.

Who Has an Interest in Control?

An effective control framework delivers more than accountability for results for the budget. As the discussion of financial information has shown, it provides managers with valuable information to let them know what is going on within their operations. Similarly, it gives more senior managers information about how their managers are performing. It also informs stakeholders about the organization's performance. It could be a bondholder assessing the credit-worthiness of an entire government. It supplies those governing the organization, a legislature or council, with the information to assess how the organization is doing financially. Finally, it permits internal and external auditors to assess the organization's financial practice, laws or policies as well as the appropriate use of funds voted.

Creating a control framework for agencies of government that operate at arm's length is an important means for governments to oversee the performance of these organizations. As governments extend their use of contracted and

arm's length operating agencies, such frameworks are key to the continued exercise of their accountabilities.

Establishing controls within the management cycle of a department or unit lets people know what their flexibilities and limits are. For line managers, it establishes the extent of their discretion and outlines the rules by which to make decisions. While many programs have well-defined parameters and operational guidelines that make up a control environment and control activities, the pressures of public service always lead to the exception, the situation that demands some flexibility, or the anomaly that has no bureaucratic direction. Program managers need to know their limits. As well, for the line manager and their managers, effective controls will address risks to the organization in achieving its goals and the degree of risk acceptance and mitigation within the organization. Finally, for the line manager and all the management hierarchy involved in decision making within the organization, effective controls will ensure that there is a timely understanding of the performance within the organization that would permit adjustments in budgets, behaviour, or program expectations to accommodate unforeseen situations and monitor the impact of managers' decisions.

In some instances, head-office managers, e.g., executives, financial officers, human resource managers, strategic planners, will want controls that will allow them to see if all the funds are needed for a program within a particular year. This is because most public-sector organizations, which are complex entities not just a single unit, have more than their share of unmet program, financial and event-driven demands that are not funded. Head-office managers are often seeking to free up unneeded funding to meet them. Equally, managers at the upper levels of an organization will want controls of a nature that will assure central agencies in their government that they are using funds effectively as an organization and complying with process requirements.

For the governing bodies of the organization, effective control means that rules about financial behaviour and avoidance of misuse of funds, together with a common framework for understanding financial statements, are in place and are being applied. This includes an assurance of the application of the government's accounting standards, as discussed in **Chapter 3: The Accounting Framework for Financial Management.** The basic level of control ensures that no one is absconding with the money. Another dimension of control is seeing that the program meets its objectives in a proper manner and with due regard for efficiency.

For stakeholders, effective controls mean that they have information about how well program managers and their organizations are using public funds. This information also shows whether they are doing so legally, obeying the laws or policies governing their financial responsibilities, and whether the funds are being spent for their intended purpose and are not being diverted elsewhere.

All the various players described above have an interest in having a reasonable assurance that public funds are spent for the purposes intended, with maximum efficiency and program effectiveness, and in the manner that obeys the law. Their interests vary in both degree and substance. They will also differ in how they interpret performance and control information. Satisfying everyone is a hard task in such a complex field.

Control then becomes a key knowledge function of the organization, the set of sensory devices needed to give continuing assurance that what is happening is what was intended and that someone is in control. Without control, bad things can and do happen and results are not achieved. Here are a few of the things a public servant never wants to hear, all of them pointing ultimately to lack of effective controls:

- Legislative authorities were not obtained to spend the funds.
- Normal financial practice was not followed and authorities exceeded.
- The budget was overspent and no one knew that it was happening.
- Contracting rules were broken and no one knew.
- Contracting rules were broken and someone knew.
- Money disappeared.
- Results and mistakes were deliberately hidden from the public.
- The program failed to achieve its objectives.
- Risks were known and no effort was made to mitigate or avoid them.
- Senior management or governing authorities were not informed of the problems in a timely manner.
- The organization lacks basic information to control its activities and finances.
- Projects were over budget and late due to poor controls.

Public-sector organizations operate on trust. This trust assumes that public funds are being spent for the purposes intended and in the manner intended. From the perspective of individual managers seeking to maximize the potential of their programs, controls provide the information they need to determine whether they are on plan, both program-

matically, i.e., meeting operational targets and financially, i.e., being on budget. For the public, control frameworks confirm that their interests are being taken care of, not only in getting the desired public-policy outcome but also in the expected manner. Control must not take place simply to enable management, it must also be seen to take place, as one of the foundations of that all-important trust factor in public-sector management.

The Control Process

The need for control has existed as long as organizations have existed. Every organization, no matter how large or how small, whether public or private, creates and uses some form of control over its activities. Such processes can be formal or informal, depending on the needs and size of the organization. For the public sector, control is a formal requirement, but extends into issues of culture and behaviour, not just rules and regulations.

Managerial control is continuous. Too often associated with rules *a priori* of making decisions or reviews *ex post* to reflect on their quality and adherence to rules, control is actually a combination of both as a means of knowing what is happening in an organization to ensure that it meets its objectives. In the public sector, it is not simply a matter of what is to be achieved but also how and by whom. Managerial control involves having in place the means, based on risk, materiality, and political sensitivity, to monitor how an organization is performing against its stated objectives, within the rules set for it to operate, and with due regard to efficiency along the way. As with most aspects of financial management, this means using controls to ensure that what you are doing now is under control, what you project to be happening with respect to achieving your results and adjusting and then retrospectively providing information that demonstrates adequate control through performance and financial reporting – present, future and past.

Aside from the COSO elements listed above, a useful way to describe what is meant by management control in the context of financial management is as follows:

> Management control systems consist of all organizational structures, processes and subsystems designed to elicit behavior that achieves the strategic objectives of an organization at the highest level of performance with the least amount of unintended consequences and risk to the organization.[2]

This definition covers many of the key characteristics of management control:

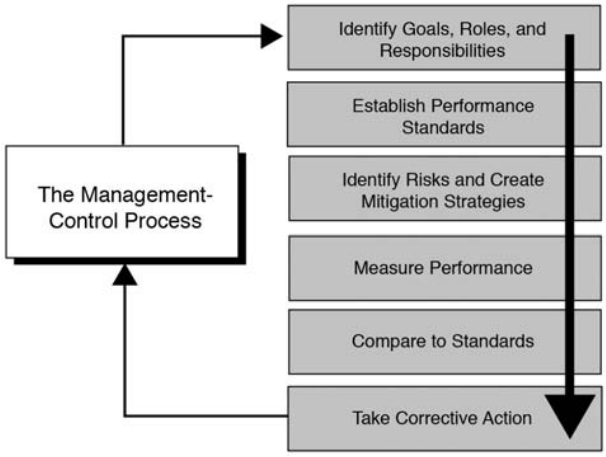
- Control cannot occur unless the organization knows what it has to do, has organized that work accordingly, and can link it to achieving its strategic objectives.
- Control extends beyond control over individual transactions and financial reporting, without excluding them.
- The objectives must be achieved at the highest possible level of performance, i.e., they must seek to be as efficient as possible.
- Risk must be mitigated so as to avoid any chance of unintended consequences in terms of either outcomes or deviations from the rules governing the work.

The architecture of a control framework, presented graphically in **Figure 8.2**, within an organization will involve certain key features:

- Organizational goals and objectives established and known
- Assignment of roles and responsibilities
- Delegation of program and financial authorities
- Performance standards, results statements, benchmarks to provide comparison with actuals
- Risk management tools in place and in use
- Risk mitigation and monitoring tools to continually reassess the risks
- Control procedures and policies, both to address the risks identified, and to satisfy legislative or policy-created requirements for adequate control
- A system of monitoring at both the operational level and the financial level to ensure that the organization fully understands what is happening relative to its goals and the risk environments
- A system of auditing and evaluation, both internal and external, that provides assurance, from an independent perspective, that there is an adequate control framework, that it is working (and not just on paper), and that the outcomes, both operational and financial, are as the organization claims.

2. Shahid Ansari, "Systems Theory and Management Control," teaching note, 2004. See http://faculty.darden.virginia.edu/ansaris/Systems%20Theory%20and%20MCS-TN.pdf

Figure 8.2
Management Control Framework



In the public sector, there are many levels of control and that control can often be imposed from outside the agency. For instance, the legislature or council is a control mechanism for the government as a whole, as well as for individual departments and agencies. Its scope of interest is essentially global – the whole government. Nonetheless, it participates in setting the goals of the programs by approving the laws that create them and the appropriations to fund them. Further, through various forms of budgetary reviews, it gets into the details of program delivery. Equally, it reviews the expenditures of the government on a regular basis, often through appearances by ministers and other officials before committees or in general sessions. Finally, in most instances, there is a legislatively appointed external auditor who serves the legislature directly, providing independent assessments of the government's performance. All these activities are functions of public-sector control and accountability. Their existence is a fundamental feature of our democratic system, and its strength.

A management control framework is designed to help the organization achieve the state of being in control, not just under control. It involves the basic steps outlined above, but they are only credible and useful if there is an active use of the results of these steps. In other words, the framework may be well written, and may involve a multi-coloured chart outlining how the control framework is designed. However, if it is not used by senior management, then it is simply meeting external requirements and is not part of the managerial culture of the organization. That is called setting the tone for effective control.

What does this mean in practice? In the first place, it means that all managers must be active users of the information that is produced through the control framework. Second, they must actively participate in contributing to the conclusions of such exercises as risk assessments and receiving and reviewing monitoring reports, be they financial reports such as a statement of operations, reports on variances in operational goals, or reports on specific audits. Third, they must manage the mitigation of risk and take accountability for it. Fourth, they must assess the overall financial condition of the organization on a regular basis and be seen to treat seriously the information they receive. They must be seen to be the active consumers of the information. In summary, there must be active management of the control framework, not simply lip service to the notion or active attention only when something goes wrong.

Risk and Risk Management: Heart of the Control Process

Chapter 2, Risk and Accountably: Core Concepts provided an in-depth look at risk and risk management throughout the financial management framework. It is useful to revisit it without repeating what is there to remind us just how powerful an element of control risk actually is. The reality is that if there were no risks, there would no need for any controls. That world does not exist. Risks, adjustments, opportunities and change abound within most government activity. As noted in Chapter 2, a control framework is also an important means of mitigating risk, either in advance or in reviewing performance.

There are two ways to think about how risk plays such an important role in an organization's control framework. The first is the risk of not having controls. This is often referred to as the failure of internal controls to mitigate risks. Internal controls is a term associated with the control systems that an organization itself puts in place to exercise effective control. Figure 8.3 outlines some of the potential risks that might arise if these controls are not in place.

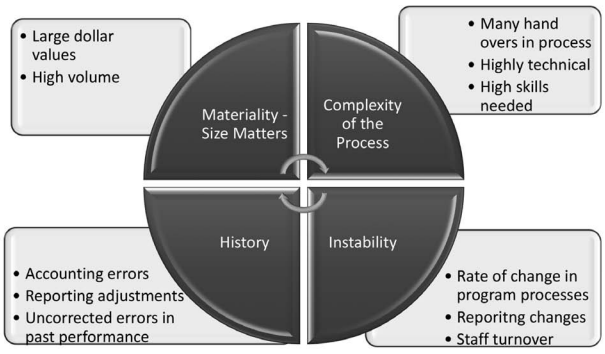
Figure 8.3
Risks of Control Failure

Having a control framework alone will not mitigate all risks. Not having one will, even with this limited list, ensure that undesirable outcomes will be inevitable. Without the many forms of control in place, an organization is running blind. Control forms the heart of how the organization learns how it is doing relative to what it wants to do and what resources it has to get there. More importantly, in the public sector context, no one is spending their own money here. It is taxpayers' funds voted by a legislature or council, be it First Nation or municipal, for public servants to achieve goals set not by them but by those legislative bodies. Mangers' roles therefore involve not just the program objective but the controls in place to assure delivery. Some of those roles are:

- Clarity in objectives and program parameters: setting performance targets, such that those reporting to them understand what their budget is, what their delegations are and how they are to report
- Identify and manage risks in a way that focuses on prevention at reasonable cost, encourages the ongoing identification of emerging risk and mitigates risk on a periodic basis
- Design, implementation and maintenance of the control structure within program processes that balance the need for service and the need for prudence, especially where large sums are involved
- Contribute direction to identify, prioritize and review risks and controls through the regular review of performance, preparedness to adapt to changes and reallocate resources where needed
- Remedy control deficiencies when they arise through audits, reviews or performance failures
- Periodically,
    - review results, reassess risks, test controls
    - confirm key controls are implemented and effective
    - maintain documentation to support this assessment.

Figure 8.4 outlines some risk triggers that mangers need to consider when identifying the need for controls. Even where the evidence of any system failures is absent, i.e., things-are-going-well-so-why-rock-the-boat view of the world, these triggers should make an organizational leader think twice if there are no controls in place, whether they are adequate and what would be the cost of greater assurance. History is rife with stories of public (and private) entities merrily ignoring these warning signs and wondering how they ended in major financial and operational failure. This is sometimes called the "whistling past the graveyard" approach to risks.

Figure 8.4
Key Risk Triggers



The final element is the governance imperative. A well-managed organization can describe how it manages its risks through effective controls. This is not a guarantee that things will always go well. Public services face many challenges, much of which is not within their control. The key to the risk challenge and how an organization builds its control framework is how effective control build resilience and the ability to adapt to sudden shifts, disasters and unexpected events.

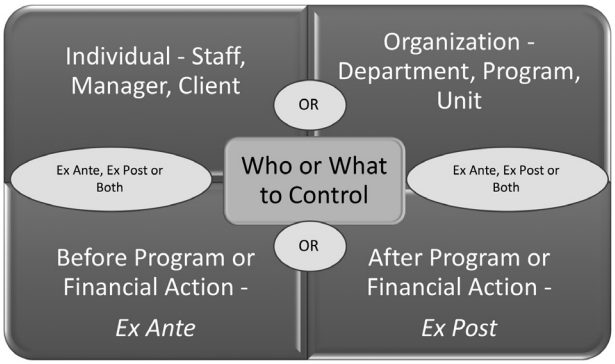
What follows is an exploration of how to build such a control system.

Control: Who, What and How

Whom to Control, When to Control and Who Has Control

The controls that an agency chooses will be directed by its take on its risks, on those things that the laws say it has to do, and on the expectations of its stakeholders. It has a number of choices. The first is whom to control and the second is at what point to do it. These issues are summarized in **Figure 8.5**.

Figure 8.5
Some Basic Choices in Setting Up a Control Framework


Individual - Staff, Manager, Client
OR
Organization - Department, Program, Unit
Ex Ante, Ex Post or Both
Who or What to Control
Ex Ante, Ex Post or Both
OR
Before Program or Financial Action -
Ex Ante
After Program or Financial Action -
Ex Post

With respect to the question of whom to control, there are two approaches: the organization as a whole or an individual, be it someone working within the organization or the recipient of its services (perhaps a person who receives money from government based on an entitlement such as welfare or tax credits). Controlling at the organizational level means establishing measurements, process checks, and audits to examine its overall actions. Applying control at the individual level will mean instituting safeguards to ensure that the individual's actions can be scrutinized either before or after the transactions occur to prevent fraud or miscalculation of benefits or to ensure compliance with rules or standards.

As to when to control, the alternatives are to exercise control either before or after the individual or organization takes action. Before-the-fact, or *ex ante*, controls involve subjecting a decision that the organization or individual is about to make to some level of review or approval in advance. An official may not be able to authorize an entitlement of more than $2,500 for any individual claimant without a supervisor's approval. They are usually incorporated into the control framework through a delegation matrix and signing-authority policies. A delegation matrix is a formal document assigning financial and other authorities to specific categories of managers. As in the example, the authority to approve expenditures up to a certain level would be defined in such a matrix. As part of the delegation matrix, the manager is assigned the authority to formally approve or sign for the transaction.

After-the-fact, or *ex post*, control involves a review process for decisions and expenditures that have already been made. In such circumstances, the actors, be they individuals or organizations, are fully responsible for the action because they had the authority to approve it and action was taken on the basis of their authorization. For example, a cheque may be issued on the authority of an individual, with no other review except to verify that it is the approved official who has that authority. Some form of control exists, through monitoring, sampling, summarized reporting, or variance analysis, to oversee the quality of decisions already made at either an individual or aggregate level. **Figure 8.6** provides a simple example of a delegation matrix. In reality, they are much more complex than this. However, this illustrates how hierarchical such matrices are, of necessity. There are also evident elements of materiality in such matters as tendering and contracting. Clearly, the issue of untendered purchasing is an important one for government and sensitivities abound. The same applies to contracting.

Figure 8.6
Sample Delegation Matrix

Process	Deputy Minister	Assistant Deputy Minister	Director General	Director	Manager
	Director	Manager			
Budget - Overall	All	All – for Branch	All – for Section	Recommend only	Recommend only
Budget Transfers	All	All for Branch to $1M.	All for Section to $100K	In-Year only up to $25K	None
Purchases – General, No Tendering	$50K	$25K	$25K	$10K	$3K
Purchases - Tendered	$2M	$500K	$100K	Recommend only	Recommend only
Contracting >$50K	$250K	Recommend only	Recommend only	Recommend only	Recommend only
Contacting <$50K	All	All	All	<$25K	Recommend only

The Array of Control Tools

The internal control environment comprises both the control environment and control procedures. The environment addresses issues of an ethical culture and the role of trust in setting control standards. Control procedures can be classified into two broad categories or systems with respect to what they do: one is to protect the resources and the other is to facilitate their effective use. Facilitative or strategic controls enable the achievement of program objectives. Protective controls are meant to protect public funds from being spent improperly or imprudently and to protect public assets from loss, theft, and damage. To express it another way, protective controls are input-oriented and facilitative controls are output-oriented.

The control framework should be set out in internal control policies, a key part in setting the tone and having an impact on the culture as well. Some of the policies needed are:

- A general control framework
- Systematic risk management tools
- Accounting policies and systems
- Policies on disbursement of funds
- Contracting, procurement and purchasing
- Conflict of interest guidelines
- Travel policies
- Security of assets and personnel
- Records, authorities and delegation.

We will be returning to some of these matters below.

The Control Environment: Trust and Ethics and Setting the Tone

Sound integrity and ethical values are critical to internal control. All controls are built around two notions:

- The trust the controller places in the organization or in persons with authority and responsibility, and
- The culture of ethical behaviour in organization.

The core elements of a successful control environment that build from these notions are:

- Consistent leadership and the modelling of ethical behaviour
- An emphasis on building the competencies for effective control
- Governance processes that emphasize the solving of problems, building on lessons learned from errors, handling errors in a corrective way, making decisions in a consistent manner and the use of performance information
- Risk management
- Monitoring of both control outputs, but also of the controls themselves to reduce complacency.

Trust

In cases of organizational control, trust is not a matter of feelings or emotion. Whether individuals are inherently trusting or trustworthy is not the matter at hand. Rather, trust is a calculation that is made by the organization about its own people, about other organizations, and about other people, as well as its leadership. Here, the waters can become murky as such calculations inevitably become mixed up with personal feelings, history, and calculations about

the gap between stated intentions and capacity to actually deliver. Making trust calculations public and transparent is not easy, and it is seldom done. Nonetheless, it plays an important role in how an organization develops its approach to control.

Trust is also an important element in balancing the desire for full assurance through control (no surprises, no errors) with the cost or improbability of achieving it. In the end, more control systems, however technologically sound or detailed, depend on the people who run them. Therefore, a degree of trust is necessarily extended to operators of the systems, on the assumption that their intentions are sound and their track record indicates that such trust is deserved, taking into account what was written above – trust is conditional and rightly subject to monitoring.

Over that time, confidence and trust are built up. Organizations value their reputation and work hard to maintain it. Talking about it very seldom cuts it: it takes a proven record. For example, a long-term, dependable supplier of service with a proven track record for good delivery and sound management is a valued asset to any organization. But trust relationships can collapse at any time. In the public sector, governments often forget the importance of these relationships when they over-react, by immediately moving to enact draconian measures of control. At that point, trust just flies out the window.

An Ethical Culture

All of this control could be happening while, with the wrong values in play, serious intrusions into public trust could be accruing. This could be either through misappropriating public funds, using them for purposes not intended, or diverting them to personal uses. It is axiomatic that public-sector organizations and the people within them have to act in an ethical manner. Therefore, ensuring that the ethical framework of the organization and its personnel is sound is yet another form of control, one that is essential to the success of all other efforts. As the Auditor General of Canada notes:

> The promotion of values and ethics is an essential part of a good governance framework that needs to be continually and systematically addressed to help ensure probity and the long-term viability of federal entities.[3]

Individual managers and decision makers are often faced with ethically challenging situations that require them to make some form of judgement, often with competing goods to be achieved. Sorting through such dilemmas is not simple. When public funds are at stake as well as adherence to the law, the stakes can be high and the pressures great.

An ethical framework for effective financial management is closely linked to how the organization is managed overall. Therefore, in thinking about the role of ethics in this one area, it is important to see that ethical behaviour is to be valued in all aspects of the organization's behaviour.[4] There is no room for "Do as I say, not as I do." That is what is meant by tone at the top.

Some of the tools that public-sector organizations use to ensure that they are promoting ethical behaviour are:

- Establishing codes of conduct or ethics
- Modelling ethical behaviour in leadership, through training and providing guidance
- Supporting sanctions for ethical misconduct
- Using merit principles in hiring and promotion
- Employing a wide variety of training initiatives on ethics for both new employees and those already in position
- Identifying high-risk positions (not persons) where either special training on ethical challenges or special surveillance is called for
- Disclosing any conflicts of interest and policies to support this, noting that this becomes more important the higher the level of the position
- Creating mechanisms to report misconduct of superiors and adequate safeguards for those reporting (i.e., confidential channels and whistleblower legislation)
- Establishing ombudsman positions
- Providing ethical counsellors, trainers, offices
- Involving professional associations, such as the CPA Canada, to develop ethical guidelines for membership.

Clearly, control does not happen without adequate values and ethics to support it. As Washington and Armstrong note:

> By definition, the management of ethics and conduct is not just about monitoring and policing behaviour. It is also about promoting integrity and good conduct. It is about seeking some consensus on what is good behaviour and giving public servants some

3. Canada, *October 2000 Report* (Ottawa: Office of the Auditor General of Canada, 2000).

4. Sally Washington and Elia Armstrong, "Ethics in the Public Service: Current Issues and Practice," Public Management Occasional Paper, No. 14 (Paris: OECD, 1996).

> guidance as to how they should act, make decisions, and use discretion in their everyday work."[5]

Therefore, addressing ethics as part of an overall control strategy makes good sense and is probably less costly than additional regulatory measures.

Facilitative or Strategic Control

Facilitative controls are linked to the strategic outcomes of the agency. They are aimed at ensuring that the organization maintains an effective alignment between its operations and its desired outcomes. Facilitative-control systems are exemplified by financial planning and forecasting systems supported by integrated financial and non-financial performance systems. They alert managers to the need to revise plans and take actions so as to correct identified problems or to take advantage of newly identified opportunities. This category includes controls designed to collect, record, and process financial data and prepare timely reports. People do not usually think of data collection, processing, and reporting as part of their organization's internal control system, but without an effective information system, there will be no evidence that the controls are working. In addition, facilitative controls are concerned with having the right people with the right skills in the right jobs. They also have a strong governance element: is their managerial oversight, direction and capacity to redirect resources to make corrections or adapt as risks are identified effective?

Controls in the facilitative category include:

- A strategic planning process that establishes the direction for the organization
- A governance system that regularly reviews risk, sets priorities, assigns accountabilities and reviews the results
- Policies to address the issues listed above and provide consistent guidance
- An audit oversight process that focuses on key risk areas
- Policies assigning responsibility for various information-gathering tasks in the organization, such as the financial officer, the financial analysis group, or a performance-monitoring group
- Reports defining the information the organization wishes to receive and analyze on a regular basis
- Reports created so they are understood by senior managers or board members and management. Overly complex or simplistic reports will result in poor communication of financial data
- Financial performance information that is communicated, along with, and clearly connected to, operational information and comparisons with plans and budgets, so that the information can be used for making decisions and achieving program objectives
- Sound financial reporting – both external and internal – is accompanied by the use of standard analytical tools such as forecasting, use of historical data, ratio analysis, effective cash management, and quality of financial reports
- Qualified staff trained on control mechanisms
- Conflict of interest guidelines
- Regular monitoring of control systems to test their effectiveness, and the provision of checklists on key activities guide staff and suppliers on the required steps for proper compliance.

Protective Controls

Protective controls define boundaries, set limits, protect assets. They are put in place to avoid error, mitigate inherent risks or as the result of a legal requirement.

The principal categories of protective control activities are:

- A delegation matrix that clearly defines financial authorities for individuals in the organization and also limits their authority, thereby requiring the approval of a higher level position or cross-check with another officer
- Adequate separation of financial duties, especially having one person who approves an expenditure (the authorizing officer) and one who approves the payment (the processing officer)
- Proper and timely authorization of transactions and activities
- Measures to control theft or fraud
- Background checks on employees in sensitive areas
- Password protection protocols
- Regular and required software protection testing
- Adequate documents and records
- Physical control over assets and records along with regular inventories
- Reconciliation of financial and related statements, variance analyses, physical inventories and audits
- Independent checks on compliance, accuracy and performance
- Establishment of error tolerances and gates that require a higher level of review
- Active supervision, including inspections

5. Ibid. 11.

- Controls to verify financial records (monthly reviews and annual audits)
- Security protocols to detect hacking and accessing of information, financial data, access to operational control systems and other inter-connected elements of the organization's operations.

These examples will involve a mix of manual and automated controls. Increasingly, first level checking of error patterns, authorization overrides, or increased incidents of correction are captured within analytical data systems that generate reports to higher level supervisors as alerts.

Testing the Controls

Having a control framework in place can create a sense of trust and confidence. It can also create complacency. As control is driven by risk and risk is such a dynamic variable in the organizational environment, the controls themselves need to be monitored to make sure they are working, are addressing the real risks and can be trusted. It is not wise to assume that, if controls are strong enough, there will be no fraud, or that errors will be identified and the financial statements will be accurate. The reality is that controls provide reasonable, but not absolute, assurance that objectives are being met. In the end, controls rely on the people who operate them. Aside from the need to audit control systems on a periodic basis, there are signs that controls are not fully effective. Some of these show up and should be taken for signals that controls might need to be rethought:

- There is regular evidence of inadequate knowledge of the control requirements, as in "I didn't know that" when the individual should have known.
- Inadequate segregation of duties, as in "We trust X who has done it for so long that we need not worry" is very clear evidence because most fraud is committed by long-term, trusted employees.
- There is evidence of inappropriate access to assets: passwords on stickies on computers, offices open inappropriately, files left lying around.
- Control as form over substance, as in "I always just sign this stuff off. No worries" could be cause for concern.
- Your senior financial advisor says, "Don't worry, be happy. I've got it all under control."
- There is control override, as in "I don't care how this happens, just do it."

Finding the Balance Between Control, Discretion and Cost

There is a tension between the level of control exercised over managers and the degree of freedom or discretion that they have to actually do the work that they are there to do. This involves many dimensions of management: decision scope, the capacity to reallocate funds, and the ability to respond to emerging situations. The key elements of control are the degree of delegated authority, reporting requirements, actual discretion, and what is seen as the time and money burden of control. The challenge is how to maintain accountability while ensuring that service is being given.

Control is not costless. It is a normal part of the administration cost of an organization. Further, governments can transfer control over some costs to other organizations when they contract with them to perform services, accompanied by reporting requirements at a level of detail that either increases overall project costs or else diverts funds from direct program delivery to supporting control functions.

Risk and public interest will drive the degree of control that an organization will want. It will also determine whether the controls should be *ex ante* or *ex post*. In general, *ex ante* controls are more costly in that they apply to whole categories of expenditures, all of which must pass through the gate to be authorized. Further, they increase costs in the sense that they generally slow down processes, reducing the efficiency of the operation and, by implication, reducing the quality of services to the recipient. Ways can be found to expedite such processes, such as defining gates at a risk level that permits some payments to go through automatically and some to be held because of risk factors, such as high cost. Sometimes this will involve a dollar threshold below which a certain amount does not require authorization or pre-audit while amounts above it involve some form of supervisory or second-opinion review. This is an example of how costs can be mitigated, even in a high-risk environment that recommends *ex ante* forms of control.

Controls can also be costly in that they may limit managerial discretion to respond to unique circumstances. This discretion is usually sought in the name of improved client service or adaptation to special needs in a specific community. Another variant on this is that managers may have to pursue higher-cost solutions to problems because policies demand certain processes even though there may be advantages to moving more quickly to find low-cost

solutions. Consider a manager seeking to stretch her funds, who sees a sale of office furniture at costs significantly below the pre-approved standing offers that she is required to draw from. Procedures do not permit her to take advantage of such savings. She could, however, use her authority to make local purchases with a government credit card to make a number of lower-cost purchases from this sale, meet her office needs, and maximize the budget potential. This would improve the office environment and, hopefully, productivity. Is this breaking the rules or applying them creatively? Managers often have to confront controls that they see as constraints that increase costs and reduce their budgetary potential.

Another cost of controls is their demands on managerial attention. What is the appropriate balance between focus on the client or program objectives and focus on taxpayers' rights to sound financial management of their resources? This rhetorical overstatement of the issue does serve to illustrate the dilemma facing many managers and organizations: when is there enough control, and at what point does it begin to reduce organizational effectiveness? There is no clear answer to such questions. While it is trite to say that a proper balance must be struck, in the public sector, control too often wins out. Of course, this is followed by accusations of mindless bureaucracy running rampant at the cost of service. Similarly, bureaucrats can become preoccupied with controls as a way of protecting themselves against criticism, or worse, when something goes wrong. This obsession with control, repeated often enough, makes it become the actual work of the organization, instead of the work for which it was created.

Things to watch for as indicators that there are excessive or inappropriately placed controls:

- Too many details make it impossible to see the larger picture.
- More time is being spent on feeding information into control systems than is spent serving the client.
- Control systems take too narrow a focus, being too financial or quantitative, to serve their strategic need.
- There is a glass ceiling on variance and problem areas in that senior managers do not give it enough attention.
- Controls are not trusted.
- Third-party deliverers of public services can suffer when government controls become excessive. In contracting, part of the goal is to transfer many of the administrative burdens to the deliverer, but contracting agents often demand a level of reporting detail that effectively turns the third party into an arm of government control. Part of what is contracted is the ability to deliver the public good. Organizations, especially in the voluntary sector and First Nations, often face a reporting burden that distracts personnel from their ability to deliver the goods contracted for.

Whatever the control framework, it must be weighed against what it costs to operate and its effect on the organization itself and its delivery systems. It also has to be weighed against what constitutes reasonable expectations of return, i.e., measuring good control against risk and political necessity. Is it worth the money? In the public sector, politics factor significantly into this calculation. That is perfectly valid, and a part of the democratic process. Hopefully, such calculation is informed and considered and not simply rapid knee movements.

The Concept of Controllership in Government

Increasingly, governments, especially larger ones, are organizing to develop centres of policy and oversight, known as controllership offices. These are intended to strengthen the government's capacity to set government-wide policies to meet the strategic control needs across departments. Some of the activities that these offices are concerned with drive right to the heart of effective control. In fact, the modernization of financial reporting and improvement of systems to support that are key control improvements that government has been able to achieve. Therefore, a controller will be preoccupied by:

- The establishment of accounting standards and the adoption of standard definitions and interpretations to permit the comparison of financial performance information
- Creation of policies for risk management and assurance that it is implemented in operating units within government
- Policies for key asset management practices such as procurement, management of assets and liabilities
- Development of a competent control community of employees within government, serving as a focus for knowledge and training development
- Integrating financial with other strategic performance information to give a full picture of performance.

A report of the provincial auditor of Ontario noted the impact of these changes on control frameworks:

> Public-sector controllers have historically focused primarily on establishing basic accounting systems

> and financial controls to, for example, ensure that government spending is within the levels approved by the Legislature. However, over the last decade there have been a number of initiatives at the federal and provincial government level to expand this traditional role of the controller.[6]

At the heart of the efforts by several governments to improve their controllership was a recognition that a disconnect had occurred, as discussed above, between the goals of the organization and the available means to exercise the necessary levels of controls. Part of that disconnect is the inadequacy of the financial community in understanding the program goals of many public-sector organizations and align the control framework to achieve them in a cost-effective and legal manner. Historically, the controllers' philosophy has been that one size would fit all, regardless of the risk, the understanding, and competence of the staff and the form of the organization. Modern public-sector controllers have had to make a major transition from the public accounting techniques of the past and also from controllership practices.

This modernization process is certainly consistent with the objectives of effective control – of an organization being "in control" rather than simply "under control." The main elements of this effort have focused on training, staffing standards, and quality of information. Many governments have moved forward with efforts to keep up with the pace of change in public-sector management in general. One of the tools introduced in the process of the modernization of controllership is the capacity checklist, which is one way to ensure an organization is keeping pace with changes and that its financial and control functions are supporting the goals of the organization effectively.

6. *Towards Better Accountability*, Report of the Provincial Auditor, 2003, Chapter 2.

Chapter 9
In-Year Budget Management

Chapter Objectives:

- Defining in-year management
- Understanding its role in budget-management processes
- Developing and applying an in-year budget management cycle
- Using forecasting and analytical tools to better manage the approved budget

As we saw in the last chapter, control of public resources is a continuous process. While the characterizations of active *ex ante* and *ex post* controls are important, managing resources within the current year requires additional tools that involve financial condition analysis as well as projections about future behaviour and plans. This is real-time control, which seeks to answer, and then do something about, questions such as:

- What has happened to our budget plan so far this year?
- Are we on target for our budget projections?
- What do we project is going to happen for the remainder of the budget year?
- How do we explain the variances?
- Where can we find funds to meet some short-term demands that are well within our mandate and authority, but for which we have not allocated funds?
- What will we do with a surplus resulting from an unanticipated drop in program levels?
- Is this a permanent or temporary situation?
- What does this tell us about our managers' performance?

By answering such questions and then taking steps to address gaps, change strategies, reallocate funds or take corrective action, managers can better ensure that resources are available to support the level and quality of services and programs for which they are responsible. A term that will be used a good deal in this process is *variance*, which has been used earlier in this book. Therefore, this chapter begins with some consideration of that concept.

Variance and Variance Analysis

The dynamic control of the approved budget depends on many variables: effective management, good information on performance and the ability to adapt to changes. These are core control functions. A principal tool in in-year budget management, but readily applicable in other forms of control, is variance analysis. Put simply, variance is the difference between what you expected to happen and what is actually happening. In the context of financial management, variance and variance analysis have a couple of important roles to play. For one, variance analysis compares monthly budgets against actual numbers to highlight differences between strategy, i.e., what you planned or expected, and execution, i.e., what actually happened. That is its retrospective role, but these variances – along with a number of other tools that we will be discussing in this chapter such projections, changes in price, shifts in client needs – are valuable tools in projecting budgetary performance to the end of the fiscal year. That is its prospective role. Such projections are a key element in in-year budget management. Variance analysis can uncover the beginnings of unsustainable trends and help the organization manage its budget in a way that is better aligned with its strategic goals and to keep on budget.

Let's look briefly at how variance analysis works. The follow is a chart showing the expenses of a small municipality, extracted from its second quarter report to the council. That means that it is half way through its fiscal year, an important point in the budget year as trends often become clearer, and the time to start making adjustments, should they be needed, has come.

Canadian Public-Sector Financial Management, 3rd. Edition, by Andrew Graham. Montréal and Kingston: McGill-Queen's University Press, Queen's Policy Studies Series. © 2019 The School of Policy Studies, Queen's University at Kingston. All rights reserved.

Town of Fort McNashExpenses Report				
	June 30 Actual	Annual Projected	Annual Budget	Variance Projected to Year End
Wages & benefits	6,098,000	12,291,000	12,616,000	325,000
Fuel	201,000	340,000	316,000	(24,000)
Winter & snow removal	866,000	1,249,000	1,146,000	(103,000)
Utilities	190,000	336,000	316,000	(20,000)
Expenses accumulated variance				178,000

Negative variances are shown with brackets in this instance. A negative/positive sign or a colour code can be used. While there is a total figure, indicating a projected surplus, it is not clear and certainly not automatic that funds from one line-item can and will be transferred to cover off deficits in other areas. For instance, the policy of the town may be that wages cannot cover off operating costs, all of which are in deficit.

While we will be exploring in detail the process of in-year budget management, there are a few clarifications to enable a better understanding of this information. This report is both retrospective and prospective, so there has already been some variance analysis undertaken. The June 30 figure is what has actually happened to date. However, the Actual Projected is not simply taking the actuals and doubling them to project them to year-end. Rather, it is clear that some judgement has been made about what the year-end actuals would be. This is normal as the producers of this information will know more about the operations than what the number suggest. For instance, there seems to be an uptick in fuel prices that mean the original budget is low. Hence, there is a negative variance of $24,000. Similarly, the positive variance of $325,000 in wages may mean that certain positions are vacant, but they may be in the process of being filled or it could mean there are staffing problems.

Variance analysis is central to in-year budget management. The ability to make timely alterations in operations or to reallocate resources early in the year guards against having to make more draconian adjustments later. However, variances do not all need to be "fixed." In many cases, monitoring is all that is needed. Further, the variance has to be material, important and substantial enough to take action. Having a variance in any control function does not necessarily indicate there is bad management. Some cautions need to be taken into account when dealing with variances:

- **Aggregation:** Summary variance numbers may mask meaningful variances and lead managers to misinterpret the condition of the organization. The small example above is a good example, as noted.
- **Materiality:** A variance has to be sufficiently large and significant to receive attention. This will mean that some form of risk analysis will be applied.
- **Related information:** A variance that a financial officer reports on a financial report may or may not be important or even accurately reflect the actual financial situation. As seen in the report above, even variances were not recorded until an end-of-year projection was added. This involved the judgement of the program manager along with the financial information. For instance, in some circumstances, mangers may front-load their purchases for the year so that they spend a lot in the early part of the year but not in the later part.

Defining In-Year Budget Management

This chapter focuses on what is needed to help answer such questions as listed above and address variance in budget performance. In-year budget management embraces a broad range of control practices associated with the monitoring of financial performance within the current fiscal year (in-year) to ensure that adjustments can be and are made to accommodate changes with respect to the plan and budget.

> In-year management is the system which compares actual expenditures against unit spending plans for a given financial year, identifies risks and variances and enables the adjustment of resource allocations to reflect changed circumstances in the that year.

The objectives of creating a system for organizational in-year management are to:

- Have funds to pay the bills (i.e., sufficient liquidity) and meet budget targets
- Use budgeted resources for their program purposes, and not leave needed funds unspent and program goals unmet

- Keep within the appropriated or authorized budget
- Have the organizational and resource capacity to react to changes in plans
- Reallocate available funds to meet emerging, short-term priorities
- Assess managerial performance, correct errors, adapt to unplanned shifts, and learn from this to adapt future budgets and program parameters.

In-year management is not a way to re-open the budget decisions but to adapt to changing circumstances. It encompasses the various elements necessary to effectively manage the assigned budget of a unit within the year over which it is to be implemented. Keys to good in-year management are:

- Effective cash-flow projections and forecasting in order to assess the organization's performance against plan and budget
- Reports to the appropriate authorities to alert them to changes, confirm that the budget will be spent according to plans, release surplus funding for reallocation, and monitor managerial performance to make adjustments in the short term
- Governance procedures to ensure timely review of financial and performance information and to make decisions to adjust programs, reassess budgets, or find alternative strategies such as increasing available funds or reallocating unneeded funds

This definition stresses that in-year management is a formal process or system. In our personal finances, most of us keep an eye on how much money we have, how much we need, and whether there is a gap. We also look to build savings or other non-current assets to deal with contingencies, emergencies or opportunities as they arise. For most budget managers, the same is true. They generally know what their budget is, how they expect to spend it, and whether or not they have the funds or other resources to meet their obligations as part of that plan. Like a private individual, many public sector managers, especially those in smaller agencies, depend on transfers from funding governments or a fee-based income flow, and will also keep on eye on their liquidity to, as noted above, simply be able to meet payroll and pay the bills.

Of course, organizational budget management strategies can be more complex and formal than the actions of a single prudent manager. They involve the systems that organizations use to manage their in-year budgets to maximum effect. They range from the manager's concerns, as just outlined, to the preoccupation of the financial advisor or controller with ensuring that adequate monitoring of budget behaviour based on reliable financial and operational information will properly signal to the senior manager that those in the organization are operating within their funding authorities, that the plans laid out in the approved budget are unfolding as anticipated, that changes are being managed or recognized, that surpluses are identified for reallocation, and that managers are performing well. Hence, there is a need for formal reporting and structures. Budget management is a core element of the overall management framework of an organization.

Figure 9.1 shows some factors that can affect the budget position in-year of an organization. There is seldom one single measure that can completely describe the relative financial position of an organization. Further, the in-year budget management process combines past performance relative to budget, an assessment of the current financial and risk situation, and projections about future behaviour. All the factors in this framework are coming into play at one time or another, as we will see when we describe the process itself. There are many moving parts and their number increases with the size of the organization and level of aggregation of decision making.

Figure 9.1
Factors That Can Affect In-Year Budget Management

Before we take a closer look at budget management strategies, it is probably wise to be reminded of what can go wrong. To that end, **Figure 9.2** offers some scenarios that are best avoided if possible. In addition, this, like budgeting, is part of financial management that is rife with gaming. Therefore, **Appendix 2** describes **The In-Year Management Games People Play.** While both are

offered somewhat tongue-in-cheek, the point is serious: how you manage the resources put into your hands reflects upon your reputation as a manager and your credibility as a seeker of more resources, expanded scope, or support in risk taking.

Figure 9.2
Some Budget Management Scenarios Most Public Managers Would Like to Avoid

Topping the Pinocchio Index	This index is the work of the C.D. Howe Institute,[1] which annually reports overall budget overruns at the government level. Its 2017 report claims that governments have overspent approved budget plans by $69 billion over the previous ten years.
Overspending the budget and knowing about it	This can be a form of risk management or a commitment to a program objective regardless of the costs. The degree of forgiveness will vary dramatically across governments.
Overspending the budget and not knowing it	This is a sign of negligence and bad management. Surprise is not a healthy part of financial management.
Underspending the budget but not meeting program needs	This is a situation that requires some nuanced analysis before coming to conclusions, as there may well be legitimate reasons for this. It remains, for the most part, something to avoid.
Underspending the budget and not knowing	See above, but dumb and dumber seems to coalesce here.
Getting financial information too late to be able to do anything about it	This situation places the manager in a bind, reduces organizational flexibility and brings into question the quality of financial advice.
Commitments that mask potential surpluses for reallocation	This is seen as a protective defensive measure, but hardly a corporate move.
Too little, too late	Funds arrive too late to spend. This leaves a surplus that may or may not be available for profiling in future years.

Budget Management Versus Budget Planning

Budget planning and budget management are different, although linked, as it is only through effective budget management that budget plans are realized. **Figure 9.3** offers some illustrations of those differences, some of which we will review in more detail. The focus of budget management is the current fiscal year, and the process describes how to ensure that the budget plan or budget is being carried out and how to react and adjust when it is not. Most organizations in the public sector, hopefully, have budgets that are known and relatively stable. For them, in-year budget management plays an essential role in fulfilling the goals of the budget process.

The objective of in-year budget management is not to change budgets on the run. Rather, it is to use the approved budget plan as a tool of control to compare actual performance with the plan. Any gaps between these two can lead to challenges: find funds, use or deploy funds that are not needed, reallocate or adapt the program service level. More will be said about these processes later, but managers will use such controls reluctantly, and only if they feel they will not permanently lose surplus funds that become available from temporary program changes. In fact, to avoid losing funds, they may well commit them as having been spent, so as not to be penalized by losing surpluses at the end of the fiscal year. This has led to all kinds of aberrant end-of-year spending as organizations try to come in just on budget without "leaving money on the table."

The one exception to this is a budget change arising from legislative or policy changes during the year. As noted in the discussion of budget processes, most governments employ a supplementary estimates or budgeting process throughout the fiscal year that allows the approval of appropriations for such changes. In such instances, the manager may receive new permanent funding. For governments, the gap in time between initiating a new cost stream by way of policy or legislation and approving the appropriation may be significant, especially for large expenditures, but there may well be strong political pressure to get the changes up and running. That is when the government as a whole has a budget management problem: finding the funds to provide interim financing. Larger governments tend to have contingency and reserve funds to cover some shortfalls. Alternatively, they can increase borrowing.

1. https://www.cdhowe.org/public-policy-research/numbers-you-can-trust-fiscal-accountability-canada%e2%80%99s-senior-governments-2017

Figure 9.3
Differences Between Budgeting and In-Year Budget Management

	Budgeting	Cash Forecasting and Management
Objective	Allocates resources, sets authorizations, limits and targets.	Project and manage gaps between budget projections and actual results.
Process objectives	Lock in and secure resources.	Maximize use of resources through corrective management or reallocation.
Main preoccupations	Government and agency priorities Projected targets for performance and restraint. Sources of revenue. Optimal allocation.	Current situation. Variance: why and significance relative to cost and risk. Action to correct and adapt. Interim reallocation.
Time horizon	Long term and permanent.	In-year and adaptive.
Variability and frequency of change	Linked to annual planning cycles, but subject to interim adjustment.	Can be highly variable within year depending on risk and volatility.
Work timeframe	Done in advance of year and with considerable notice.	As current as possible and needed. Frequent updates.

Third, in-year budget management does affect future budgeting and may well expose the inadequacy of the current budget relative to the organization's planned outputs. Managers may signal shortfalls that, upon examination, turn out to be of a permanent nature. An important question in variance analysis is whether the variance is temporary or permanent. As well, if budgets are consistently underspent, the organization may, over time, question if the amounts budgeted are too high.

A Budget in Hand: Good First Step

What follows is a discussion about how to establish an effective system to forecast, monitor, and manage the budget throughout the budget year. This is built on the simple – and perhaps somewhat hopeful – assumption that the manager has a budget in hand to manage. One of the challenges of financial management in the public sector is that this is not always the case. It is a sign of sound management within the organization when budgets are approved and distributed to operating units on time, i.e., in advance of the beginning of the organization's fiscal year. When they are not, it creates uncertainty and difficulty for operating managers. It reduces their capacity to develop an adequate understanding of budget limitations and possibilities. It also loses valuable time in the budget management cycle of the fiscal year. Managers will be reluctant to declare surpluses if they are uncertain of receiving all of the funds they believe they need. Similarly, as a precautionary measure, they may declare the potential that they will not have sufficient funds, as a means of protecting themselves should their full budget not arrive.

There are many causes for delays in finalizing budget distribution. The agency may be uncertain about its own financial position. It may be dependent, as is the case in so much of the healthcare sector and for First Nations, on more senior government funding decisions. In such a situation, moving into the new fiscal year with current staff and program levels may create the potential for a budget crisis. Not doing so can create a program crisis. In other instances, it is possible that a department or agency of government has its budget but has not completed an internal distribution. There may be many reasons: disputes over distribution, conflict between distributed funding and centrally held reserves or special funds, disputes over budget levels affecting potential operating levels, new cost formulae, bureaucratic drag or indifference. Operating managers are often left to go into the first quarter of the fiscal year without knowing the exact budget. As so many of them have, they carry on as if they had the money. Others have come to live with this problem and have reserves for such purposes.

The ideal state is that operating managers know their budgets at the beginning of the fiscal year. Unfortunately, organizations tend to repeat themselves: they develop a culture that accepts such delays as a way of doing business. While this clearly devalues good financial management in the organization and probably prevents the organization from maximizing its resources, such repetition also makes it relatively risk-free for managers to assume that, all things being equal, last year's budget, along with any changes they are aware of, is probably what will be the final product. This would at least enable operating managers to begin making projections, since this is in their interest as good managers. In all probability, an organization that cannot get its act together to adopt a budget will also accept some slippage on its budget forecasts – and wonder why funds were left unspent at the corporate level.

Establishing an In-Year Budget Management System

Any budget management system is built on three questions, shown in **Figure 9.4.**

Figure 9.4
The Three Big Questions in In-Year Budget Management (and in Most Financial Control)

The elements of the in-year management system are tied together in graphic form in **Figure 9.5** on the next page.

In this cycle, organizational roles and responsibilities will vary, but any system for forecasting, monitoring, and managing the budget will involve a combination of interests and tasks:

- **Senior management** set budgets and program direction.
- **Program managers** manage within the resources they are given to carry out programs.
- **Financial advisors** provide information to budget-setters for their decision making, as well as advice to line managers about their budgets.
- **Financial advisors** provide information and analysis to identify variances, offer comparisons and further analysis of budget performance, and make recommendations to line managers and senior managers.
- **Financial advisors** prepare reports to enable senior mangers to make decisions.
- **Program managers** respond to variances against plans, with explanations, solutions, and alternatives.
- **Senior managers** determine what actions to take on the basis of these two sets of inputs.

Preparing an In-Year Budget Management Plan

Once there is sufficient certainty about the resources available for the year – that is, the approved or appropriated budget – the challenge becomes how the funds will be spent over the course of the year. On the revenue side, most organizations can, indeed, predict their cash inflows based on:

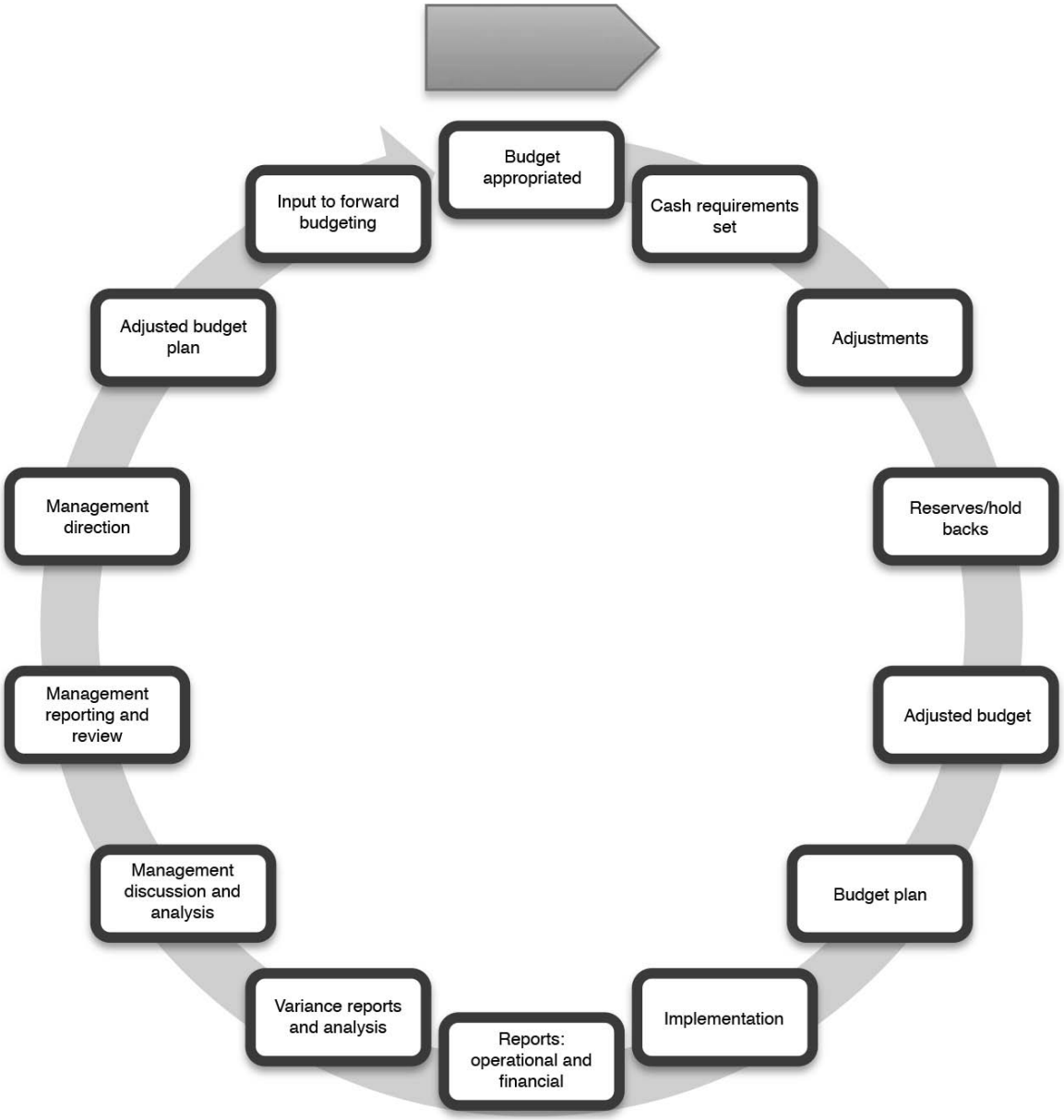
- Previous patterns of inflow in the past years
- Anticipation of any changes that might cause such a flow to be altered such a fee or rate changes
- Timing of the maturity of investments or endowments in various funds.

For many government organizations, the question of revenue flows is not one that they have to address. Budgets are set, and the manager does not have to be concerned about finding the money to meet the obligations since it comes from the government's consolidate revenue fund. As already noted, management of revenue inflows through taxes and other means is a treasury function that is attended to on their behalf. Their focus, then, will be on the other side of cash flows: the expenditure side.

This chapter is concerned with the management of expenses that are detailed in the organization's *operating budget*. Managers often see budget-plan forecasts as difficult to make and, to some extent, unrealistic. They also characterize them as straitjackets in which managers are held to account for the financial performance of their operations despite many unpredictable and uncontrollable elements. In other words, forecasts are seen as meeting some financial needs, but having very little to do with the real world of day-to-day operations. There can be some truth in this, which makes it important to build reporting systems that are both useful and realistic. This takes the collaborative efforts of managers, senior leaders, and financial advisors working together over time to develop useful and credible projections. Failure to make the effort means loss of control over one of the key elements of getting the work done – the money.

Managers who are asked to submit budget forecasts are really estimating their work plan for the year. They are assessing the environment, measuring risks and setting in place their best predictions of how resources will be spent. Some managers simply adopt the divide-by-twelve

Figure 9.5
The Budget-Management Cycle



approach, which amounts to little more than filling in the blanks. Organizations that act this way might as well not waste their time even trying to manage their budgets. They lose significant opportunities to ensure that budgetary fluctuations are managed effectively. In other words, they lose real control of their limited resources to forces they do not care to pay attention to.

Spending Plan: Estimating Budget Performance for the Reporting Period

The degree of detail needed: Should the plan be based on the approved line items in the budget? Should it be at the level of the responsibility centre head, or more disaggregated or aggregated? For instance, the responsibility centre head may have four units performing essentially the same duties, but in different locations, and with somewhat different staffing patterns, and may want to project expenditure patterns on a unit-by-unit basis to permit better monitoring of each unit's management of its resources. She, in turn, may only be asked to prepare a plan for all her units.

The period frequency: Is the plan to be built on a monthly or quarterly basis? In high-risk areas, the reporting may need to be even more frequent. Here, the issues are risk and materiality: just how important is it to know the pattern of expenditures at this level of time detail?

The treatment of one-time expenditures: Not all expenditures are spread over the year. Certainly, expenditures like salaries and disbursements and grants do, but most budgets have one-time expenditures as well. For example, the purchase of computers may be a budget item for data-processing centres in the organization. Whether it is material to know if these purchases are going to be made all at once or throughout the year will depend once again on the organization. The treasury people will definitely want to know when the orders will be filled and the accounts become payable. Those for whom this is less relevant have two options: book the expenditures in the plan as a one-time event at the beginning of the year, thereby committing the full funds, or schedule the purchases in the plan so that they can be reflected in financial monitoring later on.

The role of budget caps or conditions: One challenge for budget managers is that the senior line or staff managers at the corporate level may intervene in the approved budgets to limit the manager's discretion, or higher authorities within the organization may set an expenditure target below what the manager budgeted. In general, most budgets are not approved by legislatures at a level of detail that would reflect individual units within organizations. In fact, they are generally at the program or outcome level.

Similarly, while formal budgets may be approved by the corporate level of the organization for reporting and accounting purposes, senior management may choose to set reduction targets in certain areas to ensure that funds will be available for other purposes, or that areas of special concern are addressed as a management priority. Suppose that, in its strategic planning, the organization decides that it will need 1 percent of operating funds to meet an emerging policy need for more support to communications initiatives of concern to the minister. Instructions may be issued that all units will project their salary and other operating budgets at 99 percent of the approved budget. In another instance, the organization may be concerned about the level of overtime caused by staff absenteeism, especially staff working shifts in continuous operations. It may target a reduction in overtime expenditures of 5 percent over the year.

In either example, the budget plans have to take such adjustments to their budget into account. In fact the 99 percent mentioned above becomes the new 100 percent for the responsibility centre manager. She will have to manage that reduction and distribute it within her plan.

Any of these hold-backs would be held in a financial reserve. Remember that many governments have formal reserves in their budgeting systems. These are contingency funds, often required by law. The reserve the in-year budget system refers to would be an informal one, usually under the control of the chief executive.

Reserves or hold-backs: Does the organization distribute the full budget to the responsibility centre managers or is some held in reserve to be distributed later in the year, on the basis of need and merit? This is a complex question. Organizations follow many different routes with an eye to enforcing good management and to having flexibility to respond to emerging issues at the corporate level. Such issues can be operational, political or emergencies but they are short-term in nature.

The existence of a central pot of funds, often called a reserve or contingency fund, will be discussed further below. However, with an eye to the creation of an in-year budget plan, the real question is whether a portion of the responsibility centre manager's budget is being held back for this reserve within the year being planned. Reserves can be a useful tool in resolving budget management issues for the organization.

Arriving at an Adjusted Budget

Before coming up with an in-year budget management plan, the manager must know the exact budget he is working with. This may involve making adjustments to certain line items based on internal adjustments to arrive at the *adjusted budget*. Budgets can be adjusted any time of the year if they are affected by either the addition of new budget funds, changes in programs through policy or law, or mandated reductions. For the purposes of creating a budget plan, however, the initial adjusted budget should closely resemble the approved budget but then take into account internal transfers, centrally managed funds distributed into the budget or the above reverenced hold-backs and caps.

Figure 9.6 provides an example of a budget that has been adjusted to take into account funds held back and funds transferred for use within the manager's responsibility centre. In this case, there were a small number of adjustments that reflected some managerial concerns: the level of overtime use, some use of pooled resources to reduce costs of the purchase of equipment, and the creation of a small reserve.

Now that these initial adjustments are made, the manager is ready to begin the actual work of forecasting the financial activity over the year. This means the creation of a budget plan for the year. After that, as it is implemented, variance between actual performance and the plan for the basis of in-year budget management and adjustments.

Figure 9.6
Adjusted Starting Budget for Budget Plan Forecasting

Emergency Response Unit
Provincial Department of Public Safety
Grey Oaks Unit, Grey Oaks, Alberta

Line Item	Original Budget Amount	Hold Back, Reduction Target or Reserve Adjustment	Transfers In	Transfers Out	Adjusted Starting Budget
Staff	230,000	(35,000)[a]	45,000[b]		240,000
Overtime	85,000	(10,000)[c]			75,000
Call-out expenses	20,000		5,000[d]		25,000
Training – contracted	25,000				25,000
Training – in house	20,000		5,000[e]		25,000
Equipment: operational	50,000			(50,000)[f]	
Equipment: administration	40,000				40,000
Communications	25,000				25,000
Supplies: operational	75,000	(5,000)[g]		(20,000)[h]	50,000
Supplies: administration	25,000				25,000
Total	595,000	(50,000)	55,000	(70,000)	530,000

Notes:
a. One support position was not funded because it is under review by the department.
b. An additional response officer (junior) was transferred from a pooled allotment held at headquarters to permit more training relief.
c. Management reduction target set by the ER director.
d. Grey Oaks is designated as an isolated area, so call-out costs (mileage, etc.) are higher: additional funds from a special HQ fund.
e. Funds available for travel to this isolated area.
f. All operational equipment is managed centrally to reduce purchase costs. Transfer to HQ.
g. HQ has established an equipment reserve fund by means of a levy on all units.
h. Central purchasing of supplies will reduce costs: funds are transferred out of the unit, but all the supplies it has budgeted for will go to the unit.

Setting Up a Budget Plan

The budget plan, also called an expenditure plan or cashflow plan, is really the basis for the unit's operations for the year. It is a projection of the anticipated flow of resources, all monetized, for the coming year. As such, it is important that the managers get it as close to anticipated activity as possible. The budget plan is also the basis for comparing actual results with those in the plan, thereby beginning the variance analysis that may lead to budget or operations adjustments to get back on budget or adjust to changing circumstances.

In developing the plan, managers are expected to use a number of tools that will be discussed below or have already been touched upon:

- Historical data showing past performance
- Their program plans – the implementation side of the budget that takes into account program changes, new costs and the timing of planned expenditures
- Know commitments or specific spending plans and their timing
- Addressing risks in terms of creating reserves, creating hold-backs, etc.

In creating a budget plan, the way that the operation spends may have some unique features. For example, some operations are seasonal in nature and so staff costs may be higher one part of the year than another. This outflow, based on historical information and projected plans, should be reflected in the planned salary expenditure for the year. Capital expenditures tend to be made on a one-time basis in accordance with the capital plan. Therefore, it is wise to make these early in the budget plan to ensure delivery of the goods and also to have some flexibility if the actual cost differs from plan. There are any number of variables such as this which means that you simply do not divide your budget by twelve to get a monthly projection in the face of other evidence.

The budget plan is the way the organization assesses performance of the unit. Therefore, getting it right is important for sound accountability. In the end, the manager will be held to account for her projections and the variance that arises over the year. Projecting using sound tools is important.

It is possible to actually project surpluses or deficits in a budget plan. Look at **Figure 9.7, Budget Plan for the Emergency Response Unit.** Two instances of projections that differ from the adjusted budget can be found there on the next page. They conveniently balance themselves off, which is a matter of good luck. However, each reflects information not known during the budgeting process that changes the funds needed. There is, however, one word to the wise. The budget plan, while it has to be as realistic as possible, cannot revisit budget decisions such as staff levels or cost assumptions.

We will now take a closer look at some of the ways that managers make their projections.

Tools for Forecasting

Past performance is a powerful tool in predicting future behaviour. All things being equal, organizations will repeat their behaviour unless they make specific moves to change it. The best predictor of how funds will be spent in the future is how they were spent in the past. The manager doing the projections has to separate what is different this year from previous years which might suggest a different budget outcome. Some of the elements that may change, but that are also hopefully taken into account well ahead of this exercise in the planning and budget phase are:

- Cost changes for inputs, including salaries, approved rates, average costs or supplies
- Client demand for services as a result of changing circumstances or program adjustments
- Adjustments to approved cost formula
- Emergencies and recent major events not planned for but requiring additional expenditures.

Many public operations have seasonal patterns to how funds are spent. There are peaks and valleys of activity within programs that can be predicted using established historical patterns, an understanding of how the program works, and awareness of the operating environment. While many organizations have fairly steady flows of activity, e.g., pension entitlements tend to be stable on a month-to-month basis, some have definite season peaks, e.g., emergency welfare assistance may peak in the winter months when seasonal employment dips. Historical data within the organization should serve as a guide for forecasting future behaviour.

Case Study: Shady Gulch Provincial Park

This case shows how one park uses a number of the forecasting tools already referenced. This example is a useful one as it involves both revenues and expenditures. Most government entities depend on the government's overall taxation revenue and transfers from the consolidated revenue fund for the source of their budgets. However,

Figure 9.7
Budget Plan for the Emergency Response Unit

Line Item	Adjusted Budget	January	February	March	April	May	June	July	August	September	October	November	December	Projected Budget Variance
Staff	240,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	n/a
Overtime	75,000	3,500	3,500	3,500	3,500	3,500	3,500	20,000	20,000	3,500	3,500	3,500	3,500	n/a
Call-out expenses	25,000	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	n/a
Training, contracted	25,000		10,000				5,000					10,000		n/a
Training, in-house	25,000	25,000	25,000	25,000	25,000	2,500	25,000			25,000	25,000	25,000	2,500	n/a
Equipment, operational														n/a
Equipment, administration	40,000	10,000			10,000			10,000			10,000			n/a
Communications	25,000	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	n/a
Supplies, operational	50,000	10,000			10,000			10,000			10,000			10,000
Supplies, administration	25,000	12,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	(10,000)

Notes

Staff: Staffing is stable and no changes are forecast at this point. Therefore, projections are equalized over the year and the full budget will be spent.

Overtime: Major overtime surge is in June and July to cover vacation leave. The one new position may reduce this, but there is also the overall reduction target already factored into the adjusted budget. At this moment – prior to the start of the fiscal year – we project being on budget, but this will be a challenge.

Call-Out Expenses: In the past, these costs have been fairly uniform over the year so they are being equalized.

Training – Contracted: This is a specialized program for ER first responders as part of their ongoing qualification and support to them due to the high stress nature of the work. It takes place three times a year with an established contactor. Plan reflects last year's successful implementation.

Training – In House: This is ongoing and sessions only do not take place in the peak holiday period.

Equipment – Administration: The ERU has followed departmental practice and planed orders for equipment on a quarterly basis. As most of the equipment involves replacement of medical tools, this pattern follows the operations of the unit.

Communications: These funds are to support key communications functions of the responders, all of which is rental equipment, its upkeep and upgrading. This is based on a single contract, paid on a monthly basis.

Supplies – Operational: The introduction of central purchasing for some shared items will probably mean that not all the adjusted budget will be spent this year. An analysis of supplies purchased for the ERU function would indicate that an additional savings may be realized. At this point, based on the past three years' expenditure patterns, a quarterly purchase of $10,000 should cover known operational supply costs.

Supplies – Administration: Based on plans to convert some forms to electronic format and to reduce hard-copy record keeping, general administration supplies should be temporarily elevated for this year. To assist in this conversion, several tablets will be purchased from this budget for both ERU responders and administrative staff. As this is a transition year, regular supplies supporting legacy systems will be maintained, but diminish towards the end of the year. Tablet purchase will take place early in the year. Purchases are made every two months. The surplus in Supplies – Operational should balance this one-time overage.

as in the case of the park, part of the revenue can also come from other sources such as fees. Fees become more common, and as revenue dependency becomes a fact of life for many government services, the calculation of revenues is becoming a vital aspect of budget-management forecasting, so it is useful to look at both the revenue and expenditure sides of forecasting.

Three steps that are followed in the example of Shady Gulch Provincial Park are instructive in building a revenue forecast:

1. **Basis of calculation**: uses formulae, averages for past usage and cost formulae, usually taken from historical data that apply directly to this park or supplied by a central office
2. **Detailed projections of revenues for the planning year**: applies the formulae and makes assumptions about the coming year
3. **Summary document.**

Figure 9.8 provides the data that the park manager has been given or has calculated himself to form the basis of his projections. Most of this information is historical, based on three-year averages. Three years is a good number because it provides some comparative data and also identifies years that may be anomalous – either very high or very low – as a result of unusual circumstances. **Figure 9.9** then outlines, in detailed form, how these figures are applied to the estimated revenues for the coming year.

Figure 9.8
Shady Gulch Provincial Park
Detailed Calculations: User Volume and Income

Revenue Data Source	Previous Years' Usage		Average
Average vehicle permits sold	2004 2003 2002	1,468 1,216 1,240	1,308
Group camping rate	n/a		58
Group campsites – days leased	2004 2003 2002	125 117 125	122
Backcountry camping sites – ages 18+	2004 2003 2002	1,419 1,496 1,225	1,380
Backcountry camping sites – ages 6 to 17	2004 2003 2002	672 611 522	601
Laundry concession	2004 2003 2002	2,417 2,021 1,867	2,102
Canoe rentals	2004 2003 2002	3,4191 3,1661 31,329	32,393
Reservations	2004		5,804
3-year averages only: a. Campsites occupied b. Bus permits c. Seasonal vehicle permits d. Daily vehicle permits e. Firewood sales			 17,289 16 159 3,284 38,000

The park manager has chosen to do a straight-line projection of revenues. It is based on the assumption that use will continue to be based on historical patterns and that any changes in revenue projections will be based on a change in fees, not the rate of use. Why would he do so? First, there is little information to suggest any changes will occur. At least, none is known. For instance, there are no indicators that volume will be down in the coming years – inquiries have already started for camping sites, even with snow on the ground. Second, the Park is at maximum use already. It is a popular site and can be expected to operate at maximum demand capacity with no growth in supply, so projecting growth on a straight-line basis is reasonable under the circumstances. The manager has not been asked to either expand the scope of the camping, which would violate a policy commitment on size and scope of camping facilities in a natural setting such as Shady Gulch, nor to increase fees. Should there have been a fee increase that would have been incorporated into the calculations, it would not have affected the volumes unless the manager felt that such a fee increase would reduce demand.

Figure 9.9
Projected Camp Use Revenues, 2005: Shady Gulch Provincial Park

	Period	Sold or Occupied	Rate $	Subtotal	Total
Camping fees (all site types)					
Subtotal		17,289		$496,799.50	$496,799.50
Additional vehicle fees	May 13 – Oct. 10	1,308	$8.50	$11,118.00	$11,118.00
Group camping	May 13 – Oct. 10	122	$58.00	$7,076.00	$7,076.00
Subtotal				$18,194.00	$18,194.00
Interior/backcountry					
Ages 18+	May 13 – Oct. 10	1,380	$7.50	$10,350.00	$10,350.00
Ages 6–17	May 13 – Oct. 10	601	$4.00	$2,404.00	$2,404.00
Child			$0.00	$0.00	$0.00
Subtotal – interior/backcountry		1,981		$12,754.00	$12,754.00
Vehicle permit fees					
Subtotal		3,284		$30,704.50	$30,704.50
Summer vehicle permits	May 13 – Oct. 10	159	$70.00	$11,130.00	$11,130.00
Winter vehicle permits			$50.00	$0.00	$0.00
Annual vehicle permits			$110.00	$0.00	$0.00
Bus permits	May 13 – Oct. 10	16	$60.00	$960.00	$960.00
Subtotal				$12,090.00	$12,090.00
Reservation fees					
Reservations, booked	For 2005 season	5,804	$12.00	$69,648.00	$69,648.00
Reservations, cancelled/changed	For 2005 season	1,161	$9.00	$10,447.20	$10,447.20
Subtotal					$80,095.20
Total					**$650,637.20**

The final summary report, **Figure 9.10, Summary of Revenue Estimates: 2005–06** reflects the summary results of the first two steps. This report will be used by the administrators of the entire park system to estimate their revenues. Note that the final figure in this report includes both the detailed calculations of use of camp facilities and the other income sources, such as laundry and sale of firewood, that were contained in **Figure 9.8**.

Figure 9.10
Summary of Revenue Estimates: 2005–06

Category	Revenue Forecast
Camping & Day Use Fees	650,637
Firewood Sales	38,000
Laundry	2,101
Boat/Canoe Rental	32,393
Total	723,131

This example offers a good and intentionally detailed illustration of how one would go about estimating revenues for the purposes of budget forecasting. It is a sound basis for any form of expenditure calculation as well. The key is having relevant historical data that establish a pattern, which the manager and financial advisor feel is valid, applying them in a systematic fashion to the anticipated flow of work over the period, and then providing a summary of the information for purposes of decision making.

Another helpful feature of this example is that it illustrates the involvement of several parts of the organization in the creation of these estimates. While the line manager is front and centre in finalizing any estimates, he is only one user of this information. Similarly, he is only one party who has a stake in having accurate information. For example, line managers at the regional and provincial level will want to understand this information to give them a system-wide story of revenue flow. They will want to provide the individual park manager in advance with the formulae and calculations to ensure that all managers take a standard

approach. Central planners may actually ask the park manager to plan for and estimate a growth in campsite use of, say, 5 percent. This is more than just a number. It is, in fact, a direction to the manager to increase the use of the facility. Such a direction may, and should, lead to the manager considering whether or not he can produce such a result, what he would need to get there, and how it can be accomplished. The projection thus moves naturally into the management and planning cycle.

This information will also be used by those responsible for monitoring program performance and its bridge to the financial reporting, analysis, and in-year budget management processes of the organization. Therefore, there may be planning staff who monitor and generate some of the formulae being used by the front-end manager. Similarly, financial analysts will be providing information at the local, regional, and provincial level as well as to line managers who generate the actual figures used. The park manager may have a financial advisor or have regular access to the financial-information system that is generating information for him on the Shady Gulch's incomes and costs. It should be noted that the interests of the financial advisors and analysts extend beyond just providing the historical data. They will use the information to support and advise, but also to control and analyze. The forecasts that are developed here become part of the monitoring of financial performance over the year. They serve as the base comparator with actual performance to assess budget management within the year; that is, to assess whether the park is performing as projected by the park manager. The data enter the financial-management information system and become part of regular reports to senior managers, as well as feedback on performance to the park manager.

In this instance, the park manager will also be preparing a parallel set of projections for expenditures. Here, decisions on such issues as staffing, supplies, capital projects, and rentals will be dictated not just by the revenue flows but by the funds allocated to the park by the central offices.

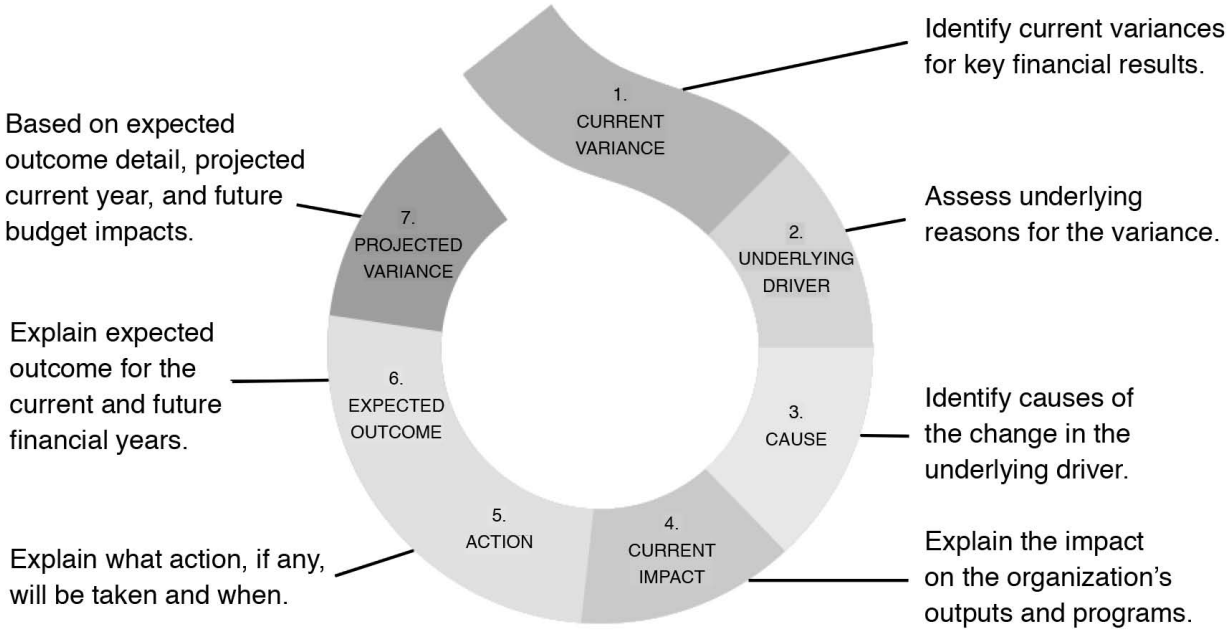
The revenue flows are obviously a concern to the organization in this example. In most government organizations, there is little relation between a revenue pattern and this expenditure-budget process. Rather, revenues are placed into the consolidated revenue fund of the government as a whole and distributed through the government's budgeting system. Given the level of detail and the amount of work that raising revenue represents for the park manager, senior managers, planners, and financial advisors, the provincial park organization obviously treats obtaining this revenue as an important goal. In addition, those parks that earn high revenues will probably be rewarded in the budget-planning process with resources to ensure that revenue levels remain high. Nevertheless, the individual parks and, in all likelihood, the entire park system, will not retain the funds they earn. Rather, they will go into the consolidated revenue fund of the province.

Monitoring Financial Performance and Variance Analysis

The purpose of all this detailed planning and projecting is to equip the organization to respond to changes in its environment, deal with unexpected outcomes, and maximize the use of the resources at its disposal. To do so, it must have information about what is going on, how it is performing relative to expectations, and where it has to focus its corrective capacity should one area face a critical situation that requires changes to be made.

This monitoring focuses on financial performance and the use of financial information, but it requires much more than that to be effective and relevant to making judgements about variance and deciding what to do about it. The focus is on how the organization is delivering on its programs' goals, specifically in the reporting period under consideration. Operational information must be combined with financial information. This will let the organization assess its financial condition in the real world: does it need funds to deal with unexpected events, or will it have the time and opportunity to readjust its spending and use funds that will not be spent for the line item for which they were originally allocated? How this process of variance analysis unfolds is well illustrated in a guide from the Australian National Audit Office in **Figure 9.11.** This is a good illustration of how accountability, both personal and organizational, play continuously to answering the questions implicit in this process. How did this happen? What went wrong? How do we correct? What have we learned about the future?

Figure 9.11
Framework for Analyzing and Explaining Budget Variances


Identify current variances for key financial results.
1. CURRENT VARIANCE
Assess underlying reasons for the variance.
2. UNDERLYING DRIVER
Identify causes of the change in the underlying driver.
3. CAUSE
Explain the impact on the organization's outputs and programs.
4. CURRENT IMPACT
Explain what action, if any, will be taken and when.
5. ACTION
Explain expected outcome for the current and future financial years.
6. EXPECTED OUTCOME
Based on expected outcome detail, projected current year, and future budget impacts.
7. PROJECTED VARIANCE

Source: *Developing and Managing Internal Budgets: Better Practice Guide*, Australian National Audit Office, 2008.

The organization therefore must establish and use reporting systems that provide information for making decisions about in-year budget management. Usually, this will be coordinated by the central financial group, along with whatever staff support units have a strong interest in such decisions. In large organizations, this information rolls up to the central office, often through intermediary structures, e.g., regional offices, shared services or headquarters, which also add some measure of analysis and decision making. Some organizations will expect operating unit to manage some of the variances and shortfalls within that unit's current adjusted budget. Internally, there may be subunits on which the local manager is gathering information regularly in order to manage the operations. Further, large regional structures may also be expected to deal with many of their budget requirements through delegations from national headquarters. Depending upon the materiality of the issue being measured, it may be that only regional totals are wanted for higher-level consideration.

Regardless of the complexity of the system, in-year budget management reports must answer several questions:

- Are we going to be within our budget allotments?
- Are we operating according to our budget plan?
- How does our performance compare with relevant historical data?
- Does this performance mean that more funds may be necessary or that some funds may become surplus in this area and thus available for reallocation?
- What are the variances, and why have they occurred? Are they material?
- What is the responsibility centre manager going to do about negative variances?
- Are positive variances within a retention range for the local manager, or are they available for needs outside the unit elsewhere in the organization?
- Do we have the authorities to reallocate these funds?
- What does this information tell us about the performance of the manager in this unit?
- What does this information tell us about the long-term funding?

Questions like these should form the basis for a checklist of key steps in effective in-year budget management.

Governance

The cycle of in-year budget management reporting should coincide with how the organization governs itself. Governance is less about hierarchy than it is about how an organization oversees its goals, makes decisions and the rules for getting decisions made. If timely financial performance information is provided to senior management,

they should be in a position to do something about it in a useful manner, not simply take note. Receiving monthly or quarterly reports, but not having them analyzed and considered for decision making, may meet some bureaucratic need but produce few results, so reports should position senior management to ask, and get, answers to the types of questions that are listed in the previous section.

From a broad organizational point of view, the cycle of in-year budget management should feed into the forward budget cycle of the organization. Most governments have a cycle of supplementary estimates designed to approve appropriations for departments to deal with new programs, program changes, and sudden cost increases within the fiscal year. The organization can use the supplementary-estimates process only if it has adequate information about its current financial situation. That being said, most governments will have little sympathy with departments that have cost overruns which they can generally be expected to manage within their own authorities and allotments.

Setting Up a Monitoring Timetable

All organizations receive regular financial reports. Setting them up and linking them to operational data varies with need, risk, and the general way managers work within the organization. For example, some organizations will want to monitor high-risk budgetary items more frequently than those that are seen as stable and lower risk. A major overtime problem within an organization, as often occurs with operations operating 24 hours a day, 7 days a week (24/7), may be subject to intensive review and reporting – even weekly if a critical stage has been recognized. It is certainly possible to set up a budget plan to track weekly expenditures on such items, but how realistic the plan is will depend on the quality of historical information and the ability to gather information on a timely basis. Most organizations will want to establish a pattern of review that makes it possible to gather performance and financial data on a regular basis with some certainty and in a standard format. Developing the right format takes some time and experimentation. Generally, a quarterly review is frequent enough to permit the organization to identify areas of both cost overruns and potential surpluses.

For the Eastbrook Correctional Facility, the federal facility in the example that is developed here, the fiscal year begins on April 1, so the first quarterly review is at the end of June. Subsequent formal reporting would be required at the end of September, December, and March. For most organizations, the first review does not establish trends for that year, but certainly permits comparison with previous years. Because it is so close to the beginning of the financial year, it is too early in the financial cycle for any major changes to have occurred relative to the opening budget plan. Even at this early stage, though, some aspects of the budget process do lend themselves to projections. For instance, a major capital piece of equipment approved in the budget is expected to arrive in December. The manager has set up her budget to plan for it to be expensed at that time and paid for then as well. This will be a one-time expenditure, not a continuing one. Early in the year, she learns that there will be a major delay in getting the equipment, so the funds might be available for other uses. This permits the organization to reprofile its equipment expenditures to take advantage of this variance. Reprofiling is a means of either reallocating funds within a fiscal year or moving an expenditure to future years. The essential balance of the budget is maintained, but plans are reprofiled to reflect the new reality. The original manager should not be penalized for offering up surplus funds. Rather, because she was upfront about the delays, she should be assured that the major equipment will be part of her budget next year. An incentive of this kind is vital to getting honest and open reporting.

Performance Reports

The nature of the financial-performance reporting will vary. In some cases, the information will simply be a quarterly comparison of budget plan to actual performance. Others will provide more detailed operational information. The example in **Figure 9.12** looks in detail at two particular line items at the Eastbrook Correctional Facility: custodial staff costs and overtime.

Figure 9.12
Budget Figures

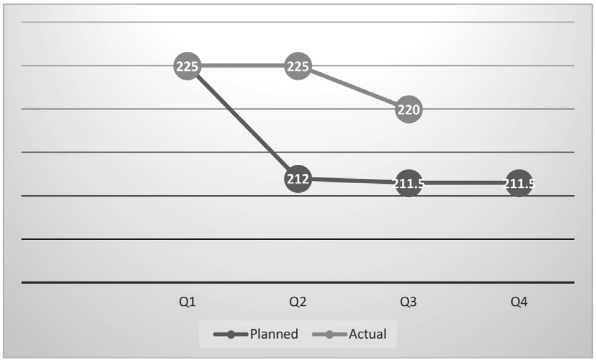
Eastbrook Correctional Facility Eastbrook, Nova Scotia Quarterly Financial Report, December 2017 Staffing and Overtime, Custodial Staff Only	
Total staff (custodial)	225
Average salary	$61,000
Total budget cost	$13,725,000
Adjusted salary budget (operating target = 211.5 FTEs[a])	$12,900,000
Total overtime hours budgeted	54,900
Total overtime budget (full allocation)	$2,745,000
Average cost per overtime hour	$50

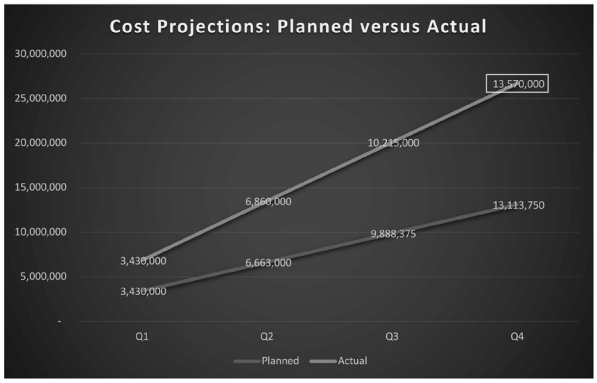
Note:

a. FTE = full-time equivalent.

In this instance, the first line of the quarterly financial statement shows that there are 225 custodial staff on strength, which would cost $13,725,000 for the year. Facing adjustments that reduce the overall budget, the facility finds itself effectively overstaffed and must therefore reduce overall staff costs to meet its actual adjusted budget allocation. From an in-year budget management perspective, this means actually reducing staff to an average of 211.5 over the year because the facility has started the year above the target. In order to meet this average staff level target, the plan, as indicated in **Figure 9.13**, envisages a dip below the target to achieve the average outcome.

Figure 9.13
Staffing: Budget Plan Versus Actual





The first chart shows a projection of the actual number of staff on complement at the end of each quarter relative to the plan. While numbers are small in this example, we can see how difficult it is for the manager to bring the complement of staff in on target. The current rate of attrition and retirement would suggest the target will not be met. The second chart tells an even more difficult tale. Based on the staff levels, this chart converts the Planned and Actual staff complements into costs. Note that the final number for Actuals is a projection based on nothing changing, i.e., a staffing level of 220 remaining. These projections tell two tales, neither of which is positive. First, even if the manager succeeds in reducing staffing to 211.5, he would still be over the projected budget of $12,900.000. Given that this is a target and that he started the year at a disadvantage, such a shortfall might be forgiven and funded. Second, while we only have figures to the end of the third quarter, a straight-line projection of Actual produces a projected deficit that is even higher. The variance between Planned and Actual while not dramatic is material as it involves staff reductions and a specific target being set by the correctional service.

Figure 9.13 reports on performance against the budget plan. This report identifies a variance against plan but provides little explanation for why it happened. In operational terms, the manager has not been able to get his targeted staffing levels down to the desired levels. This will have operational impacts that may also lead to increased overtime costs as staff are hired on overtime to fill positions left vacant due to the staffing shortfall. In fact, at this point in the year, it is safe to predict that the target will not be met. In-year budget management has to start at the beginning of the year, not at some point during it, especially when adjusted targets impose the need to change staff levels.

Variance Reports

The variance report identifies differences in financial and operational behaviour from what was expected by the organization in its budget plan. There are many types of variance report formats that could be used. However, they will have these two main elements.

Forecasted Versus Actual Report: Reporting Material Differences

Only material and substantial variances should be reported and submitted for action, either by the responsible manager or by superior levels of the organization. There are no easy rules for judging the materiality of the variance against plan. It requires that all parties in the process have some awareness of, and sensitivity to, the context of the variances. In the example of the correctional facility, the front-line manager has been given a staffing target below the planned operational needs of the organization. Whether or not this is appropriate, let alone achievable, depends on both historical trends and the fiscal and strategic direction of the facility and its senior management. Further, the materiality will also be judged by the immediacy of the problem and the organization's overall flexibility. In some cases, variance is only reported if it exceeds a certain

percentage of the established budget plan for the year. Managers on the front line and those higher up, as well as the financial advisors, should all have roles in assessing the materiality of the variance and the actions that might be taken. A variance report by itself is of limited use. It must be accompanied by information that explains the situation.

Analysis of Key Variances Report: Understanding Cause and Impact

Due to the need for such contextual information, forecasts of plan versus actual must be accompanied by an analysis of why differences or variances occur or are anticipated. From the financial side, a number of analytical tools are useful to set the variance in context:

- Historical comparisons
- Cost of the variance to date (i.e., how much of the actual budget has been spent)
- Projected variance if nothing changes (i.e., the straight-line projection)
- Variance in comparison to similar units in the system
- Variance in comparison to a previous time period, and
- Relevant financial ratios.

The manager of the correctional facility must also analyze:

- What caused the gap between expectations and results (e.g., fewer retirements or transfers than planned)
- Workload determinants that changed in actual performance (e.g., inmate population increases and the opening of a closed housing unit to accommodate an emergency influx of inmates)
- Cost drivers that need attention (e.g., excessive posts)
- Limitations of the budget itself
- Actions that could be taken to correct the situation.

A manager who fails to meet budget plans may be put under the gun. For a wry look at this, see **Appendix 2, In-Year Budget Games People Play**. Examining variances is also a key accountability tool for senior management. It is incumbent on the organization to determine the materiality of variances, the risks they pose and what steps it might take to rectify the situation. The following are some considerations for senior managers when looking at variance reports:

- Is this trend going in the right direction?
- Is this isolated to this unit, or is it a general phenomenon?
- Did we set realistic targets?
- Can we fund the shortfall that we see emerging?
- Is this manger delivering? If not, is this enough to force us to take some action, such as removing him and finding some else?

Management Actions to Correct Variances

The whole purpose of having a system of in-year budget forecasting, variance identification and reporting is to be able to correct undesirable trends, adapt to changing circumstances such as costs, workload and demand and, if necessary, find ways to cover the variance through reallocation of funds from elsewhere in the budget. A good system provides an early warning of emerging risks. What steps can a manager take to make corrections to bring her program in on budget at the end of the year? The list of potential actions is a long one. Here is but a sample of the range:

- Review commitments (both formal and informal) to determine flexibility to shut down or slow down
- Reduce staff where this will work quickly and without further costs, e.g., severance
- Keep positions vacant
- Slow down staffing processes underway
- Delay supply and equipment orders; put them off until the next period or next fiscal year
- Cancel travel and conference attendance
- Slow down program delivery schedules
- Eliminate services
- Decrease office hours if this achieves a savings
- Review shift schedules to reduce staff and overtime load
- Increase fees or internal charges for services: this may not be achievable in the short term.

Before taking any of these actions, the manager has to be satisfied that she understands the root causes of the variance. It is only then that appropriate corrective actions such as those above will work. If the variance is a permanent change in circumstances, an in-year fix will only work in the short term. The manager needs to alert her leadership and advisors of this for budgeting purposes for future years.

It is only once the manager has exhausted all internal steps to reduce variances that the possibility of the reallocation of funds, either inside the program or from reserves or surpluses in the department as a whole should be considered.

Reallocation and Readjustment

The final phase of the in-year budget management cycle involves adjustments to the available funds for the man-

ager's use based on the variance reporting and analysis. This is a governance function that makes the process truly a financial-management exercise and not simply a matter of providing financial reports that do not get used. It is also a way for organizations to manage themselves over the course of a financial period to meet demands or circumstances that no amount of sound planning and budgeting can accomplish. Therefore, not only must variances be identified, but the organization must have a very good notion of its actual capacity to reallocate. Should it find itself facing extraordinary costs due to unforeseen catastrophic circumstances – for example, the Armed Forces are called into peace-keeping missions in extraordinary numbers, or medical officials face widespread health emergencies – then the organization may not be able, in and of itself, to carry the cost burden. That is why the supplementary-estimates process is so important.

These exceptions of catastrophic events aside, larger governmental organizations are generally expected to make every effort to build in sufficient reserve capacity for managing financial variance in the normal course of events. Two ways that are common to many government organizations are the creation of formal contingency reserves in the budget cycle and the holding back in a central fund of some portion of certain budget funds in the anticipation that they may not all be needed, or that they can be freed up later in the budget year when they are needed. Both of these tools provide senior management responsible for the overall budget with greater flexibility.

Authority to Reallocate

Large public sector budgets are seldom approved at a detailed line level, as we have noted. This permits some flexibility to move funds from one line item to another. As we have seen, rules exist to limit this, but it remains a possibility. For example, general administrative funds are not broken into operating units by the legislature. They are distributed by the departmental senior management and so can be reallocated. Certain barriers to reallocation may exist and may create situations where the organization has funds to meet needs but cannot use them. Some examples of such rules are:

- Funds specifically voted for a single program, called dedicated or reserved funds
- Rules created by central agencies that forbid the reallocation of certain funds, such as the movement of capital funds to cover operating expenses, or the transfer of supplies or equipment funds to salary dollars
- A specific ministerial or political commitment that funds designated for a specific program will be used only in that program
- Restricted funds created by special-purpose endowments, or with rules that the monies cannot be moved from one fund to another.

The senior management of the organization has to know not only the formal rules governing the reallocation of funds but also the potential organizational and political dynamics of reallocation. This requires some judgement about the reaction of specific stakeholder groups to the redirection of funds that were designated to an area of interest to them. This is likely to be negative despite the fact that the funds would not have been spent in any event, because there is one reality that both stakeholders and internal managers confront when they see and hear of reallocation – the potential for permanent loss of the funds in future budgets.

Freeing Up Funds

Budget projections involve two factors: actual performance and the ability of managers to forecast expenditures and thereby commit the funds. Committing the funds means that the manager is certain that the funds will be spent.

The firmness of these commitments are matters of concern when material variances demand action. Suppose that a manager commits that all grant funds are going to be spent within the fiscal year. In doing so, she may not have the grant documentation for all grants signed and in place so the expense would not have yet been recorded on the financial statements. But she knows, based on her plans, that the grants will be spent by the end of the fiscal year so she reports them as fully committed. That gives the manager maximum protection from raids by the money-seeking financial folks, let alone her boss, who probably could use the money elsewhere. Unless there is information otherwise it is assumed the manager is reporting truthfully and the commitments are real: grant applications have been received, they are being processed in a timely way, and the demand for grants meets or exceeds the supply. Thus, the manager sees a full year for the program. Sometimes, the manager is less than truthful: applications are low, and the processing has ground to a halt due to delays in ministerial staff approvals. The money just is not moving, but the manager resists giving it up, especially if she fears permanent loss of funds or even in-year flexibility.

It is at this point that the challenge function by financial advisors becomes important. The challenge function in-

volves an informed questioning of the interpretation that managers put on information, and even on the decisions they make, by staff within the organization who are in a position to assess that information on the basis of their financial, planning, and operational expertise. This task often falls to the financial advisor, especially when it comes to budget forecasting. Organizations depend on this function as a form of control to temper excessive short-term enthusiasms or ensure that financial information is interpreted accurately. Therefore, should a manager have a history of committing funds and then lapsing or seeking internal reallocations within his unit, then those analyzing the reports must bring this to the attention of senior managers.

Similarly, senior management, facing a series of financial challenges, may ask managers to review their commitments to see what funds can be freed up. In parallel, they may ask the financial advisors to review these same commitments, to make use of that challenge function.

As well as looking at individual managers' budgets for reallocation, departments or governments can create such tools as reserves with controls on the release of funds and corporate hold-backs that hold a certain percentage of the funds until needed, as noted above. Reserves are generally created to give senior management some flexibility or by law for contingency safeguards. The question of when to free them up is one of timing and competing demands. One problem with using them up too early is that it reduces flexibility later in the year. Conversely, holding reserves too late might mean that they will not be spent and lost. The search is always for the Goldilocks solution.

Finally, senior management will have to make some risk decisions about reallocating funds. Risks are not always dangers; they can also be opportunities. However, once money is reallocated, either from a general reserve fund or from one program to another, it is not available for other uses so there are opportunity costs involved as well. Therefore, in considering a reallocation, even with the best variance reports and information, a number of risk factors should be taken into account:

- Can the situation be brought under control within the year?
- Can it be brought under control better than it is now?
- Would moving funds from manager A's budget to manager B's create a new program risk?
- Would this reallocation exacerbate or create a dependence on central reserves?
- Would this result in managerial behaviour that is not wanted in the organization, such as rewarding poor management, discussed below?
- Will any reallocation reduce our overall flexibility? Are we going too far? What redundancy do we have to respond to changing circumstances?
- Are we confident in our overall reading of the situation?
- Will this increase or decrease the danger of coming in over or under budget?
- Would this just be a bandage, covering up a real problem that we should be addressing now? Would it buy us time to fix the underlying issue?
- Will this create political and stakeholder problems?
- Will this create the appearance or accusation of misuse of funds for purposes for which they were not voted?
- Will this create inter-agency problems or transfer costs to other agencies of government? Can we tolerate that?

The Danger of Rewarding Bad Management

When a budget variance is uncovered, one question always comes up: "Is this a bad manager? Are we just rewarding bad management if we step in to help?" Financial information on in-year budget management is an important tool for senior management in evaluating organizational and individual performance. It may be a case of finding funds to meet urgent needs and, at the same time, assessing whether the manager could have managed better to improve financial performance. Senior managers are often in the position of allocating or reallocating funds even when they feel there is bad management. The reality is that they must meet short-term, high-risk needs, even if it sometimes means giving money to a bad manager. When this becomes a pattern, then senior management does have to address the manager's individual performance. Failure to do so will be noticed by other managers, who will become even more reluctant to give up their flexibility when they feel bad management is being rewarded.

Building Incentives and Protecting Budget Integrity

As evidenced in **Appendix 2, The In-Year Budget Management Games People Play,** it is possible for both an organization and individual managers to play a lot of games to protect their turf and avoid losing funds that may actually be needed elsewhere. There are also any number of manoeuvers to avoid blame for variances. The organization can act in ways that enhance the disincentive for honest forecasting and reporting if it consistently ap-

pears to reward bad management and poor forecasting by meeting the short-term resource needs these often create. There is little incentive for good budget management if there are no obvious consequences for the bad managers involved or if the budget and management structures that seem to perpetuate the problems are left intact. There are a number of behavioural and structural ways for an organization to prevent its in-year budget management system from falling into gamesmanship and thus losing its usefulness and credibility:

- **Consistent governance**: Senior management need to consistently review budget performance. They need to engage line managers and financial advisors in providing advice and analysis. They need to set in place the rules of the game that ensure good management is rewarded, surpluses are identified early and every effort is made to support managers in stressful situations not of their own making. Above all, they need to keep an eye on the performance of managers and make sure they have the skills and support they need.
- **Leadership fosters the right culture:** Organizational leadership create rules, both formal and informal, that encourage good budget management through a system of training and cultural practices that foster honesty and collegial support. They also ensure that short-term budget issues are managed in a context that balances help and corrective actions and that links to the overall planning systems of the organization.
- **Good information:** Organizations need to get the reporting right, combining financial and operational data on a basis that everyone understands and uses. There is a heavy reliance on a manager's budget plan as a real plan, on historical performance and on performance comparisons among units and years.
- **Incentives and disincentives:** Organizations need to ensure that bad management is punished, even if short-term financial help is needed when things really go wrong.

The Crucial Relationship Between Line Manager and Financial Advisor

Organizations cannot rely solely on either their line managers or their financial advisors for all the information they need to assess and manage their performance. As noted several times, highly reliable financial information is predicated on a budget plan based on the operational plans and expectations of the organization.

Financial advisors play a number of roles:

- **Challenge function or a controllership role**: This is often vested in special units in large organizations, usually called analytical units. The reporting where this occurs is typically in the variance reporting and the analysis that accompanies it. This analysis may or may not directly challenge the manager's version of the results. For instance, if the manager says that a performance problem is an isolated incident that will not recur, the financial advisor may point out that, according to an analysis of the historical data, this is the third year of such overages. It is up to senior management to determine the significance and reliability of these two versions of the same events.
- **Information support:** They provide the support function of ensuring that financial information is provided and linked to operational information, and that regular reporting is on time and of good quality.
- **Technical advisor to managers:** All managers in the agency need the advice of their financial advisers. They can be helpful in sorting out solutions, finding sources of funds and recommending ways to free up funds. This problem-solving ability comes with experience and an understanding of the operational side of the business.

It is also, to a degree, incumbent on both the line manager and financial advisor to inform each other of their positions and try to arrive at a shared understanding of events that reflects their information and views. In the end, organizations depend on this inherent tension between line and functional advice to bring out hard truths to enable good decision making.

Summing Up

In-year budget management is a skill that involves both the manager and the financial advisor. It is essential in ensuring the best use of scarce funds to achieve public goods. The following are important attributes of an effective in-year budget management system.

Effective Governance

Careful attention to in-year budget performance has to start at the top and be consistently practiced with consequences. "Nobody's ever asked us before to focus on it" is a very simple way of saying that the senior leadership in the organization does not care about its current budget situation – it has other concerns. Because no one cares, no one measures, and no one manages. To ensure good budget management, the organization has to set up ways of governing the process. Organizations that have tight

budgets or highly volatile operational or program demands are more likely to do this than those that seem to have excess capacity.

The degree of risk and need will probably dictate the amount of budgetary monitoring throughout the year. In addition, the degree of interest by senior management in financial issues will also indicate the amount of time that they want to spend on it. Nevertheless, effective public management means being increasingly aware of the relationship between resources and their use. Using the transactional, lower-management element of a financial-management system without the other element – the oversight and governance – sends signals within the organization that effective use of resources is not considered important. It also invites deal making among managers just to survive. Eventually the web of these deals will mean that senior managers have lost effective control of their resource base. Further, as pressure on governments mounts to find funds to reallocate to higher priorities, knowledge of the budget situation and use patterns becomes an integral part of the capacity of senior managers to make effective decisions.

For an in-year management system to be effective, it must be seen to have the attention and support of senior managers. While the danger always exists that such processes will drag senior managers into too many details of operations, they must have information at the right level to make decisions about the budget situation of the organization. This means that there is pressure on financial advisors at the senior level to have good reporting systems. A quarterly review of a department's financial situation cannot bury the participants, let alone the CEO or deputy minister, in details. Therefore, the form of reporting must be appropriate to the needs of the level reviewing it. It must also lead to relevant decision making in which the focus of the most senior group may be on a small number of sensitive areas that require it the most. This is the heart of exception reporting of variances.

Giving Assurance to Good Management

Not all budget management problems result from bad management. Similarly, not all surpluses mean that the managers are performing well. In fact, they may not be meeting their program objectives, but rather managing money in such a way as to save it rather than benefit the program. Nevertheless, the in-year budget management system must provide some assurances to managers who have surpluses or commitments that they might be able to shift into another financial period, so that they will not end up losers overall.

While it is difficult to set up the ideal system to prevent such things from happening, some techniques are available. First, rules can be set in place within the organization to permit some retention of surpluses from one financial period to the next. In smaller public-sector organizations, this is not an issue, because funds are self-financing and retained funds are simply kept. In larger governments, the annual appropriation system ensures that all funds not used within the financial period return to the consolidated fund. That is changing now, as an incentive to avoid excessive year-end spending of surpluses and to reward good management. Often governments permit a form of carry-over of some percentage of the year-end surplus. This encourages a more open declaration of surpluses, to some degree, as some assurance of carry-over can be built into the system. Further, the organization can reward good management of funds by distributing the carry-over on a corporate basis to those whose financial performance is good.

It is always difficult to incorporate protections against the potential loss of future budget levels. The simple reality is that a continued pattern of under- or overuse of funds may signal the need for budget adjustments. The budgetary cycle of well-managed public-sector organizations should be long enough that single events do not trigger a decision of this kind, but as patterns emerge, they must be responded to.

Rigorous Review of Commitments

It has already been noted that commitments are an important part of budget forecasting and management and offer managers assurance that funds can be committed (even though not actually spent) and thus protected for their intended use. Commitments can also be abused and can be misleading to senior managers. For example, if a manager simply commits all discretionary funds without a specific plan, this is a form of protectionism that may distort the manager's actual needs and probable use of resources.

It is at this point that the challenge role of the financial advisor comes into play. The advisor should monitor and question commitments to test their firmness and accuracy. Commitments should be treated not as money already spent but as what they are: intentions to spend money. Thus, they can become de-commitments under review or challenge. As well, faced with a major challenge, senior management

may direct that managers review their commitments to see which ones are binding and which are flexible.

The objective of good budget management is to meet the multiple bottom lines of public-sector financial management. Ideally, all funds will be spent by the end of the year. Otherwise, why plan and budget in the first place? Program needs are just as important as budgetary ones.

Section 4

Measuring and Reporting Performance

Chapter 10
The Reporting Framework

Reprise

This section builds on the foundations laid in the Introduction and Section 1. It takes the model of financial management outlined there to its final stage – accounting, reporting and review or oversight. Review **Figure 0.1.** Section 4 addresses the issues of the rationale for reporting, both internally and externally, financial statements as the main tool of external reporting and performance measurement and monitoring as the principal means of internal reporting, combined with financial information and, finally, different tools of oversight including internal and external auditing and various means of ensuring transparency. This section will also integrate accountability, risk and accounting principles in the public-sector context, bringing together the key elements of public-sector financial management. In the end, accountability only works when performance is measured accurately, in a timely manner and in a useful manner.

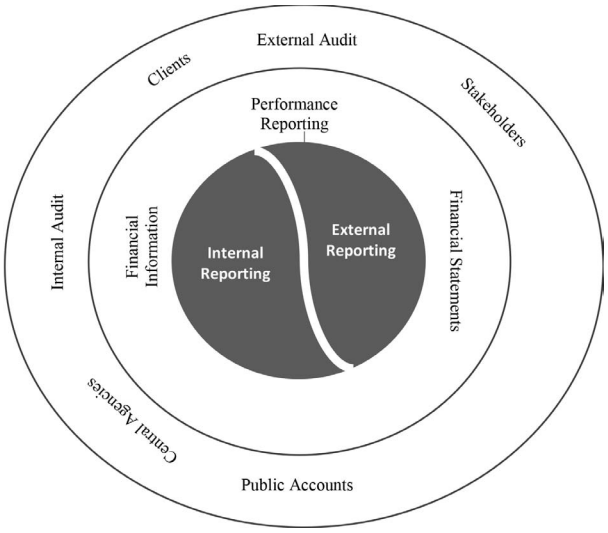
Why Measure and Report?

Measuring and monitoring a government's financial and operational performance is at the heart of how it communicates its performance, its viability and its sustainability. Combined in the many ways that governments report today, these tools are intended to provide the basis for assessing performance by internal and external users, understand how tax dollars have been spent, respond to changing circumstances and confirm that objectives are being met. The whole architecture of public sector financial management depends on it.

Governments need information in order to both manage themselves and to report on their performance so that their legislatures can assess their performance, along with a myriad of other stakeholders, as noted below. Therefore, there is a requirement for both internal and external reporting tools. In terms of internal management requirements, this is a complex field, often with internal reporting to manage in-year budgets, as already discussed, or the need to report compliance with internal government requirements or provide financial statements compatible with the government's accounting standards. Therefore, internal users abound. Similarly, governments have to provide understandable and standards-compliant information to the public in the form both of financial statements and performance reporting.

But this phase of the financial management cycle is not just about a government putting out information in various formats. It is also about oversight bodies assessing that information, ranging from attesting that financial documents conform to standards, to evaluations of value-for-money, and integrity in the management of funds. Oversight and transparency are important values in our democracy. The framework for measuring and reporting is outlined in **Figure 10.1., Framework for Measuring and Reporting.**

Figure 10.1
Framework for Measuring and Reporting



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The Relationship of Accountability to Financial and Performance Reporting

Thorough, clear and accurate disclosure of operational and financial information is essential to accountability, and is generally a mandated requirement for provincial and broader-public-sector entities**.** The Treasury Board of Canada defines financial reporting in the following way:

> Financial reporting refers to financial reports and disclosures that are both internal and external to a department. Internal financial reporting can include financial information that supports decision-making, planning, budgeting, resource allocations, accounting, performance assessments and reports. External reporting includes all financial statements, reports or disclosures, including those prepared for Parliament or to be made public.[1]

Reporting is an important tool of accountability. It indicates how the individual or organization has provided good management and stewardship of funds. It can provide information on the results achieved. For example, financial data will tell the user if the budget as approved was spent and for the types of uses prescribed. It cannot say how effective those expenditures were. It can, once audited and certified by the responsible manager, provide assurance that the organization has managed its funds within the procedural requirements. Combined with program results, it can provide information on the relative efficiency with which the objectives were achieved. At that point, the report becomes a performance report with financial and performance data combined and linked. **Figure 10.2, The Accountability Dynamic** repeats the schematic from Chapter 2. The point in this diagram relevant to this whole section is the bottom arrow. Accountability is exercised through information confirming performance.

Figure 10.2
The Accountability Dynamic

Authority, power, resources, goals
Individuals or organizations accepting accountability
Individuals or organizations conferring accountability
Accountability for performance, results, and efficiency
Financial and performance reporting

Good financial management, therefore, is at the heart of establishing accountability as it is conceived in this text. One of the features of public-sector accountability is that it is transient and volatile, often shifting as events occur, becoming political and controversial. It is therefore really important that the core accountabilities be tied down, well measured and consistently reported. Much depends on trust in those providing the information. Having sound financial systems that produce reliable data is a means of establishing such trust. Janice MacKinnon, Saskatchewan's minister of finance during a time of real crisis in that province, relates how important good financial information was in making decisions about the crisis:

> In the 1990s accountability for public finances improved dramatically. All government agencies were required to make regular and timely public reports; many provinces moved to an accrual accounting system, which meant that public costs have to be recorded as soon as commitments were made, rather than allowing such expenses to be moved forward to some future date; and all provinces moved to "summary financial statements" – a single financial statement that included the financial results from all government agencies. The latter was extremely important in preventing governments from hiding deficits by moving money around among different government agencies… At least in the future,

1. Treasury Board of Canada Policy on Financial Resource Management, Information and Reporting. See *www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=18796&section=HTML*

taxpayers would be fully aware of their government's fiscal situation.[2]

This confirms the importance of accurate data, standards of compliance and verifiable financial statements in gaining and retaining confidence in what is being reported. Some key questions to ensure that financial statements are able to address such underlying concerns should be:

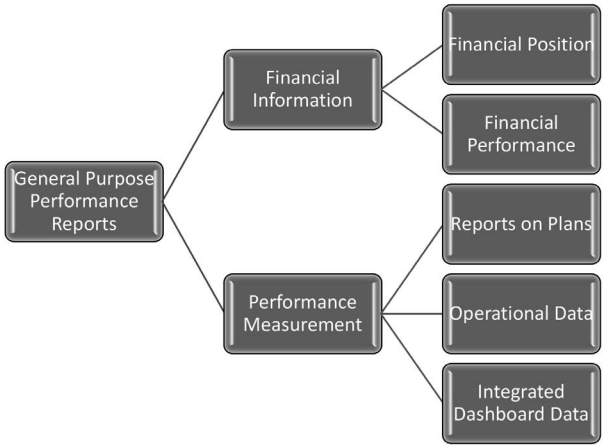
- Are the reports compliant with PSAB standards that apply to the government?
- Have accounting policies been fairly represented in the Notes to the financial statements?
- Is there a clean statement of representation from the auditor?
- Has the government accurately described its entity so that users can understand the scope of the entity being reported upon?
- Is actual-to-budget comparison information provided in the financial statements?
- Is there a clear statement of revenue recognition?
- Are explanations provided in the Notes for changes in net debts, capital asset evaluation and capital asset condition?
- What is the reserve or contingency capacity of the government?

Performance information, built around financial and operational information, has to be able to answer questions such as:

- Has the agency provided its services in an efficient and effective manner?
- How did the agency finance its activities and meet its cash requirements?
- Were revenues from current-year taxation and the agency's other resources sufficient to cover the cost of current-year services?
- Was part of the burden of paying for current services shifted to future-year taxpayers?
- Did the agency's ability to provide services improve or deteriorate compared with the previous year?
- What resources are currently available for future expenditures and to what extent are resources reserved or restricted for specified uses?

When combined, financial and performance reporting is meant to provide a full picture to the user. Financial information on its own provides information on both the performance of the entity and also its current financial condition. When linked to performance data, the picture is more complete, as we discuss below. **Figure 10.3** offers a schematic of the kinds of information that is provided in general purpose financial reports.

Figure 10.3
Financial and Performance Data



More will be said below about the interaction between financial and performance information.

The Users of Financial and Performance Reports

An important quality of financial information is that it has to meet the needs of many different users and for a variety of purposes. Public agencies, organizations and governments have a number of audiences for whom financial performance reports are prepared. As already noted, there are, however, two reasons to report performance: to account, both internally and externally, and to manage, with a strong but not exclusive emphasis on the internal. Often performance reports serve both purposes. For instance, formal financial statements have a universal draw in terms of both internal and external attention. However, monthly operational and financial data will be a concern to internal managers. Some of the users of them are:

- **Citizens:** The ultimate accountability for governments is the citizens they serve. They are, after all, the prime funders of governments. More importantly, they elect the governments.
- **Media:** From time to time, the media will need to look at a statement of financial position or, at least, some of the reports on performance in key areas of their concern.

2. Janice MacKinnon, *Minding the Public Purse* (Kingston, ON: McGill-Queen's University Press, 2003).

- **Interest groups:** Those who represent recipients of services, advocates for particular causes, or those who serve as general watchdog bodies will want to use financial information that the organization provides as a way to understand what is going on, to assess the organization's effectiveness or determine if their group's interests were met.
- **Research bodies:** The Canadian Tax Foundation[3] is a non-profit body that conducts extensive research into the tax system. In doing so, it provides more insight into financial management issues. Of course, research in academic institutions and other policy institutes rely heavily on financial performance information.
- **Legislatures and councils:** These are the authorizing and legislating bodies that retain ownership of the organizations in legal terms. They set the rules. They have the ultimate accountabilities – to citizens or organization members.
- **External oversight bodies:** While we will deal more fully with external auditors and other oversight bodies later on in this chapter, they play an important role in serving the legislatures that create an organization, and as independent reviewers of financial information and the maintenance of accounting principles, appropriate financial management practice, as well as issues of efficiency and effectiveness.
- **Internal oversight bodies:** Similar to the above, organizations will create internal audit and evaluation groups to monitor and assess financial reports.
- **Central agencies of government:** Central agencies must take what is termed a "whole of government" view of financial information and performance audits. However, their role in providing this view is dependent upon the quality of the information that is provided by the many departments and agencies of the government.
- **Senior managers within agencies and government:** Financial information and reports are used internally as well as externally. Therefore, there are users within organizations that have a strong interest in both the integrity of the information for monitoring, decision making, and tracking performance. See the next paragraph for more detail on this group.
- **Senior governments or agencies that contract out services or are responsible for other delivery agencies within the government:** This is a growing field of government concern. As governments devolve the delivery of specific services to specialized agencies within government, usually under the oversight of policy-setting departments or ministries, they remain fully accountable for these agencies. Reviewing their performance data is an essential part of their continuing oversight responsibilities. Similarly, in large, complex and long-term contractual relationships, as the buyer of the services, government agencies will have a legitimate interest in the financial performance of the supplier.
- **Individual donors and funding organizations:** It is highly unlikely that funding organizations will provide more funding when they lose confidence in the organization's ability to manage its finances. Similarly, some public organizations may have direct oversight and control roles in relationship to other public organizations. This is most prevalent in the government/voluntary sector interface. Financial reporting and its quality may have an effect on the long-term financial support that is given.
- **Creditors and credit-rating organizations:** Applying to both governments and the voluntary sector, one of the first concerns of any lender will be the financial condition of the organization.
- As noted, financial and performance data is also part of reporting to management. This is the provision of reports in a timely manner for internal use. Often this information is provided more frequently, is less structured, and more attuned to monitoring resource flows within a specific period. Some of the users of these reports are:
- **Line managers:** Line managers need to know what is going on for control and cash management purposes. They need to be able to make adjustments in operations and budgets based on these.
- **Senior management:** Go back to the cash management cycle as well as the budget cycle in previous chapters and you'll see the need for information on performance is clear.
- **Internal oversight bodies:** This category includes two groups: central units that advise the senior management and pull together overall corporate information, most notably the central finance office, and internal audit groups that have a duty to identify risk and make recommendations for improving errors and validating the quality and trustworthiness of internal reporting.
- **Staff:** Employees need to know how the organization is doing. They need feedback on performance at an individual level, but also at a unit or corporate one.

3. See http://www.ctf.ca

The Objectives of Financial and Performance Reporting

At the heart of good reporting is meeting the accountability contract that the agency has with its authorizing body. Such reporting will be based on the direction, resources and delegations that were received to do the job. Providing reports therefore, should make it possible for the users of this information to assess the discharge of the accountability taken on, and make decisions about the public good, the means of delivery, the resources allocated to it, and the political consequences of all of this.

To do this, effective public-sector financial and performance reporting should effectively:

- Demonstrate the organization's accountability that enable users to asses that accountability in a manner that is mutually understood
- Assess the financial and operational performance against budget and plans
- Provide sufficient information to permit users to assess the financial condition of the agency, to assess whether current revenues and expenses will meet program objectives, or impose future liabilities on future taxpayers
- Show that the agency is compliant with its legal financial reporting and contractual requirements
- Provide information about the organization's level of service and capacity.

The Canadian Comprehensive Audit Foundation (CCAF), now known as the Canadian Audit and Accountability Foundation, published ***Reporting Principles: Taking Public Performance to a New Level.***[4] It defined some key concepts that remain relevant to our thinking about reporting performance:

> At its core, "performance" is about how well an entity or program is accomplishing what is intended as measured against defined goals, standards or criteria. More broadly, performance may also relate to efforts, capabilities and intent. Terms such as organizational performance, program performance, financial performance, environmental performance, or the conduct of public business are sometimes used to circumscribe the scope of performance matters being dealt with.
>
> "Public performance reporting" refers to the formal mechanisms that a government uses to communicate with the public and legislatures in accordance with agreed guidelines. It is the formal response to a desire or need to report performance to those who have a legitimate interest in knowing, understanding and assessing performance, and then acting on this information.

In the report, CCAF also recommends nine principles to provide direction for public performance reporting in Canada.

> These principles reflect a unique integration of the differing perspectives of legislators, managers and auditors – three groups with an important stake in public performance reporting. Taken as a set, these core principles provide a guide to judgment in the preparation of reports (but not a template for what they will say or deal with).

The general principles recommended by CCAF are:

1. **Focus on the few critical aspects of performance:** Reports need to bring out the most important and highest risk elements of performance. Performance reporting should be at the right level of generality, not so detailed as to overwhelm the user of the information. Performance reports should address what the organization had identified as its priorities in its planning documents or accountability contracts.
2. **Look forward as well as back:** The report stresses the need to link results to previously set expectations and to report past and future projected information in a consistent manner to facilitate user understanding of where the organization has been and where it is heading.
3. **Explain key risk considerations:** The general state of effective risk management among public-sector organizations has already been discussed. The report suggests *"Reporting should identify the key risks as viewed by management, explain the influence of risk on choices and directions and relate achievements to levels of risk accepted."*
4. **Explain key capacity considerations:** The CCAF report highlights the importance of informing stakeholders about resource allocation implications on the ability to achieve goals and strategic objectives.
5. **Explain other factors critical to performance:** Increasingly public sector organizations are finding new ways to address the factors that contribute to their success or that can deter it.

4. Canadian Comprehensive Audit Foundation, *Reporting Principles: Taking Public Sector Performance Reporting to a New Level* (Ottawa: Canadian Comprehensive Audit Foundation, 2002).

6. **Integrate financial and non-financial information:** This will be discussed in the following section.
7. **Provide comparative information:** *"Information about the results of comparable organizations helps show the reasonableness of performance expectations and the potential for improvement."*
8. **Present credible information, fairly interpreted:** Reports should be credible and reliable. Using standards of reporting is key to making this happen.
9. **Disclose the basis for reporting:** Users of financial and performance reports need to understand why reporting is being done the way it is. They need to know the basis of accounting in financial reports. They need to know how performance measures were arrived at, how they are relevant, and how they compare year to year.

More recently, PSAB's ***Standards of Recommended Practice***, have identified certain key risk areas upon which combined financial and non-financial reports should provide information:

- **Sustainability** – The degree to which an organization can maintain its existing financial obligations with respect to both service commitments to the public and financial commitments to creditors, employees, and others.
- **Vulnerability** – The degree to which an entity is dependent on sources of funding outside its control or influence, or is exposed to risks that could impair its ability to meet its existing financial obligations with respect to both service commitments to the public and financial commitments to creditors, employees, and others.
- **Flexibility** – The ability to meet service and other obligations if circumstances change; for example, the ability to respond to reductions in revenues or increased costs.[5]

To conclude this section on the objectives of financial performance reporting, here are five questions that individuals and organization should ask when they set up their reporting structure:

1. Does the measure support the organization's strategic goals?
2. Does the measure support the organization's operational processes?
3. Is the measure easy to understand?
4. Can the measure be found in obtainable data?
5. Is the measure a good indicator of the organization's performance?

Integrating Financial and Non-Financial Information

Public-sector organizations generate and receive a lot of information about how they are performing. They pursue a large number of objectives and activities that are the source of this information. Some are inputs – e.g., how many people are employed and where. Some of these are processes – e.g., number of applications reviewed. Some involve outputs – e.g., number of kilometers of roads repaved. Some involve a direct or indirect contribution to outcomes – e.g., reduced crime, a healthier public. Public-sector organizations are measured in a variety of ways, often by different groups or interests. In the public sector, while there is a general desire to address results as the primary focus of organizational behaviour, the means used are important in the public sector as well. This means asking how things are done and answer questions such as: Were the legal requirements met? Were resources distributed equitably? Were entitlements met? Therefore, there will be a series of measurements that involve both operational and financial information.

Bringing together all this performance information into an integrated whole is seldom seen because of the ambition required for the undertaking and because it can be very costly. Very few public-sector organizations have realized full integration, but a lot are trying. The realistic test becomes deciding what measures are needed and useful to allow the organization to meet its requirements. This is part of the materiality test that is discussed below. One of the best efforts to bring such data together in a useful way for both internal management and external reporting has been some variation of a balanced or holistic approach to reporting. In this, information about finances, operations, clients and organizational learning are balanced to provide a complete picture of organizational performance. Here, too, organizations have experienced challenges to sustain a balanced approach as it is challenging to find an array of measures that, in the end, provide the meaningful information that managers need.

Integration of financial and non-financial data does not mean that all data must look like financial data. Similarly, not all the information that managers require to manage needs to be of the kind that financial data must pass. No one single measurement – a sort of amalgamated number or, even worse, colour code – is going to do it for complex

5. Cited in Jason Reid, "Reading the Story in Public Sector Financial Statements and Annual Reports," *Beyond Numbers*, February 2013, http://www.ica.bc.ca/kb.php3?pageid=5265&mobileSession=70f2b41f663d0fa248fa5e2118ff18d3

public agencies. In turn, organizations that place too much stock in financial reporting alone have a distorted picture of their performance. This can also place an inordinate burden on the CFO to act as if she or he is the sole purveyor of performance information that meets all the needs of the organization.

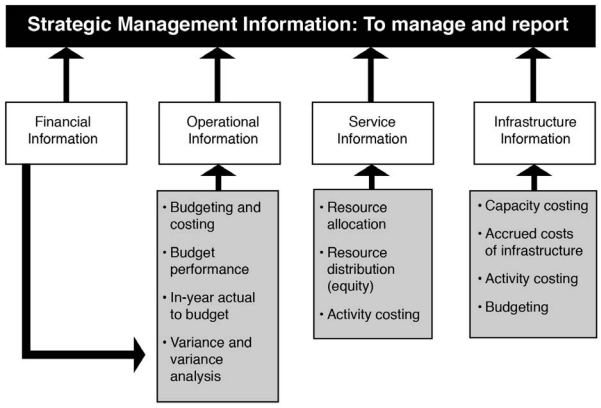
There is an important set of connections between financial and other performance information. That is, the ability to know what things cost, to understand the nature of those costs, and to apply that information in the continuing management of them. In other words, reviewing operational information without a sense of the full costs of the operations means not fully appreciating the inherent risks, the potential for budgetary distortions, or the creation of opportunities such operational information can produce.

Another example of connecting non-financial and financial information is in the so-called softer areas of performance management: client satisfaction, public opinion, and the vital issues of organizational capacity, ranging from infrastructure costs to staff alignment. Even in these areas, financial information plays an important role. For example, where issues of public service are involved, there are also often questions of the equitable distribution of resources, either regionally or by category of entitlement. Such information will have a financial base.

With regard to infrastructure and organizational capacity, two important examples highlight the role that financial information plays. The first is the ability to cost staff training, development and other investments in people. The second is the ability to use the potential that accrual accounting and budgeting gives to overall infrastructure costing in terms of planning and costing changes. This will help the organization determine its capacity to continue to deliver the same or better levels of service.

Figure 10.4 shows how financial information integrates with other forms of information as part of the input measures for each category.

Figure 10.4
Relationship of Financial Information with Other Performance Data



Financial performance information has been used for decades as a surrogate for overall organizational performance. Because financial performance can be readily measured, it has been readily available. However, it seldom tells an organization how it is performing with respect to its public policy objectives. As Norman and Gregory have noted,

> The emphasis on gathering information for accountability purposes has resulted in a flood of safe, measurable, financial information about assets that are relatively trivial components in the production of outputs. Information about human capital issues, which is crucial for ensuring success in people-intensive service organizations, is relatively scarce. Similarly, public sector organizations have had legal financial reporting requirements well before any requirements to report on results.[6]

Ideally, a fully integrated system of performance measurement would have financial and cost performance – along with operational performance – information combined with a longer-term set of measures that relate to overall policy outcomes, stakeholder interests, public support, and organizational development.

Reports and More Reports: A Sampler

It is impossible to give a definite list of the kinds of reports that make up a performance-reporting regime. They

6. Richard Norman and Robert Gregory, "Paradoxes and Pendulum Swings: Performance Management in New Zealand's Public Sector," *Australian Journal of Public Administration 62*, no. 4 (December 2003): 35–49.

vary considerably. There are standardized reports such as consolidated financial statements as well as less formal, but equally rigorous, internal reports for management use. The following lists offer a sample of the kinds of reports that one would normally expect to see in any agency of any size in the public sector. It is not definitive, although as we will see in discussing the annual reports of agencies and governments, certain statements are essential.

Examples of external reports are:

- Statement of financial position
- Statement of operations
- Statement of change in net debt
- Statement of cash flow
- Quarterly reports
- Public accounts
- Annual reports
- Audit reports
- Results-based reports
- Performance measurement reports

Examples of internal reports are:

- Operational data
- Actual to Budget reports
- Variance analysis
- Financial ratios
- Efficiency measurements
- Scorecards/Dashboards
- Cash Flow projections
- Audit reports

These will be explored in greater detail in the next three chapters.

Annual Financial Reporting

Format and appearance vary so dramatically that it would be impossible to display even a representative number of annual reports that public sector organizations produce. In general, all jurisdictions in Canada require their governments to produce annual financial statements. Increasingly, as Janice MacKinnon noted, these increasingly resemble the financial statements we will examine in the next chapters, but with considerable textual embellishment. The annual report therefore tries to bring the two forms of reporting together, increasingly in ways that is readable and relevant to citizens.

Most governments produce forms of performance reporting, based either on government-wide performance targets or targets for individual departments. Most standard-setting accounting organizations for government recommend that annual reports contain information that addresses the following:

- Management Report: introductory information and management's discussion and analysis
- Consolidated Financial Statements
- Auditor's Report
- Notes on the Financial Statement

Many public organizations meet the standards of reporting described above, but increasingly try to link the financial information to performance and risk issues. As this has developed, annual reports have become longer, more linked to the stated objectives of the organization and often with more of a publicity orientation in order, it is argued, to increase readability. In essence, organizations see this as a way to "tell their story." They also look for ways to do so that does not frighten away citizens with their detail. Of course, they also try to make them attractive and readable.

Reporting can take many formats and is not restricted to a traditional annual report. As mentioned, increasingly, a successful reporting system for a government will link the financial results and the program or policy objectives. As this develops, it is even more important to ensure that the basic financial information is sound and does not get lost with all the other information provided.

Larger governments will separate detailed financial information from their performance reports and will only report summary data in them. However, they do provide such information through their public accounts documents, which are submitted to their legislatures on an annual basis. For instance, the federal government has the following main reporting instruments:

- **Public Accounts of Canada**: These include the annual audited financial statements of the Government of Canada and information for Crown corporations, departments and other reporting entities.
- **Departmental Results Reports**: These report on the results achieved by individual departments and agencies in relation to the Departmental Expenditure Plan, which had been previously tabled in Parliament as part of the budgeting and estimates process.

Smaller governments will usually have an external auditor's statement contained in the report.

Future-Oriented Financial Statements

For virtually all accounting activity, the perspective is historical. What has happened and is it reported accurately? In a relatively new development, some countries, most notably New Zealand and Canada, have introduced future-oriented financial statements as part of their reporting suite.

This use of projected financial statements, more common in the private sector, has come into play in Canada, with the federal government's adoption of the requirement for all agencies to publish them. The objective of such documents is to show the forecasted financial position of the agency at the end of the budget cycle or projected to the end of the future years' budget cycle. In putting together such statements, the agency will be making a forecast, not a projection. The distinction is important in understanding the use and limitations of future-oriented financial statements.

A forecast in this situation means using the assumptions built into the budgeting cycle that create a financial plan in the first place along with any known changes that might affect the outcome. Based on its plans and understanding the current operating environment or awareness of any policy, technology or environmental changes, it would forecast its financial position in future periods. A projection also reflects an agency's planned course of action, together with a greater focus on uncertainty and risk. If we go back to the chapters on control and in-year budget management, managers are challenged to make predictions about financial outcomes on a continual basis. They also use financial and operational information not normally reported in financial statements.

The utility of future-oriented financial statements is in setting the stage for future accountability, using the financial statement framework. In other words, the real use of these forecasts will be found after the period is over and performance is assessed. Another important use, found in the example of the Government of Quebec example below, is in assessing core assumptions in current financial statements to determine program sustainability.

Three examples of public sector use of future-oriented financial statements are:

Canada: The federal government has required departments and agencies to include future-oriented financial statements for a number of years in the portfolio of financial statements. In providing this information, departments operate under the following assumptions to make the forecasts:

- The future-oriented financial information is finalized on the basis of current government policies and the overall environment at the time of forecasting.
- GAAP and the government's own accounting standards are applied.
- Its funding, as approved through the federal government's budget system, will enable the department to produce the results it identified in its Departmental Plan.
- Historical costs are used.

These qualifications, which appear in virtually all the reports within the federal government, are a sound means of seeing the forecast nature of such reports.

New Zealand: The Government of New Zealand has been producing future-oriented financial information since just after the turn of the century. Here is it called the Statement of Performance Expectations. It is linked directly to the Statement of Performance Expectations as agreed with the agency's minister.

Quebec: The Government of Quebec has made an innovative use of future-oriented financial information. It passed legislation that requires the Auditor General of Quebec to produce a pre-election report on the state of public finance in Quebec. Unlike other provinces which require similar reports that certify the statement of the current financial statements, with a strong focus on the state of debt in the province, this report focuses on the sustainability of current programs using future-oriented forecasting. The methodology is consistent with practice in other governments but applied in a unique way.

All Performance Reporting Should be Material and Affordable

The concept of materiality in the context of financial statements is well understood and has been discussed in this text. Standards are established by the PSAB and the internal accounting policies of government. In the financial reporting context, materiality is established by either quantitative or qualitative methods. Qualitative matters are those that may not necessarily be material in pure quantitative terms but may be viewed as material because of the specific impact that they have on the reported results or the nature of the matter itself, where a certain level of precision or absolute accuracy is expected. We see this most notably in the reporting of high profile but low value cost items such as ministerial travel.

However, materiality is just as important in the assessment of performance information as it is for financial informa-

tion. The challenge is to define materiality in any specific program. What is it important to measure? From whose perspective? In performance data, program information may involve both qualitative and quantitative measures? Which are the most important? To what level of detail? However, the differing nature of the non-financial information produced and the absence of any specific guidance means that there are no equivalent rules of thumb when setting materiality for performance information. The qualitative aspects of materiality for non-financial information may also vary significantly, especially where reporting against targets and performance is judged on whether or not the target has been met or where the information is open to interpretation. It is more than fair to criticize a government or department for not collecting the most material performance data. What is harder is to determine objectively what it should be. Further, as we will see in **Chapter 12, Performance Reporting**, both what is measured, and the level of detail measured, will involve what can be measured reasonably and at what cost.

Issues to consider when determining materiality might include:

- The level of detail to be reported
- The degree to which the information matches the business logic of the program
- The linkage to key variables such as input costs, outputs and outcomes
- User's information needs
- Cost implications of gathering the information.

Often considerations of materiality in measurement will be driven not by a quantitative notion of risk but be a policy imperative. For example, if a government has made a commitment to reduce wait times for specific procedures such as hip replacement, the metrics involved in monitoring this performance area will be detailed, even though overall health outcomes may only be marginally affected. There are also areas when the measurement of input costs is detailed and highly controlled as there is a strong interest in these, e.g., the number of public servants employed. There are also areas in which complete accuracy is needed, as any small change in program performance can affect the overall outcome. We see this in highly technical projects where precision and its measurement are a much needed assurance that the ultimate outcome will be sound.

Risk plays an important factor in determining the materiality of performance measures. In general, the higher the risk or the presence of untested assumptions, especially in the development of new programs, will increase the need and potentially the frequency of reporting, thereby elevating the materiality of the measures. Such an enhanced level of precision in measurement may be transitory, with materiality changing as experience in the program develops confidence in the business model and reduces materiality of reporting.

Materiality and level of reporting have to be addressed to avoid confusion and waste of resources. Setting materiality of measurement is a governance issue that should not be left to individual programs or their managers. The level of materiality should also be clear to the users. They need some assurance that the measures are relevant and accurately reflect anticipated program outcomes. Even non-financial reporting, therefore, should disclose the basis of reporting.

This might suggest that governments and their program managers should measure performance to the greatest level of detail that they can. Materiality means quite something else. It means being relevant to the level of detail needed to provide an adequate understanding of the performance of a program within reasonable cost parameters. Cost of reporting is a factor in determining materiality along with risk, level of interest and genuine needs to manage the program. However, burying program managers in reporting requirements that make it difficult to do their jobs is hardly good management. It happens and that is unfortunate.

Cautionary Tales: Why Key Users Do Not Use Performance and Financial Reports

The entire cycle of public sector action and accountability depends on the production of information about how governments performed relative to their plans and their budgets. Governments make great efforts to produce financial statements that receive audit clearance and provide accurate information. They also produce program results information in a wide variety of forms as we will see in Chapter 12. They increasingly try to produce this information in ways that key users can readily understand it. In doing so, they often, however, also fall into the potential trap of making this information too superficial and too much of a public relations exercise, with plenty of pictures and colours. Of course, financial statements, which we will discuss in the next chapter have a prescribed format that reduces the element of public relations but also increases the inaccessibility to those not versed in the use of statements.

Reasons for the problem of accessibility and usefulness vary. Looking at three key groups of users, it is worthwhile

to reflect on the limitations and impediments in the use of government-generated performance data. Governments produce this information to meet the requirement to do so, to inform citizens of how the government is doing and to build trust in both information and program integrity. The reality is that this information is less used and less useful than its producers would like. Some of the reasons are:

- **Legislators**: There are many reasons why legislators do not use performance information, many of which are unfortunately part of the political culture and government-legislative dynamic:
    - **Quantity**: There is just too much information put in front of legislators.
    - **Relevance**: The organization of the information may not meet the needs of legislator as it too general or not in the interest zone of the legislator.
    - **Cultural**: Governments and their bureaucracies tend to view what they do from a resource and program perspective while most legislators will focus on specific issues and impacts on individual citizens.
    - **Attention**: Legislators are generalists, with multiple agendas and concerns, while governments break down their activities into silos called departments and agencies that concentrate expertise and focus on specifics.
    - **Time perspective:** There is a lot of truth in the much-heard comment: "Politicians think in election cycles." They tend to focus on immediate issues and only deal with program detail when something goes wrong. The reports on performance take a longer term view, often glossing over individual incidents and addressing trends or aggregating information.
    - **Credibility:** Legislators often see reports, particularly performance reporting, as a public relations exercise, with the information having no relevance to their concerns.
- **Citizens:** Citizens make very limited use of performance reporting and financial statements. This has been established in many reports around the world. But, to step back, they will use this information for specific rather than general purposes. If they have an interest, they will seek out information about it. Seldom, however, do they take a whole-of-government look at performance. Some of the reasons also suggest some solutions, many of which are being tried in various governments in Canada and around the world:
    - **Complicated presentation:** The presentation of performance reports has followed a bureaucratic approach to completeness and detail that has overlooked communication and key points. Detailed financial statements, which are absolutely needed, tend to scare away those not comfortable with numbers.
    - **Relevance:** Individual citizens need to see themselves when reporting on performance. In general, such reports are general and widely applicable. That is why many governments, most notably municipal governments, are working to produce reports that are more specific and citizen-centric.
    - **Confidence:** Citizens, unless they spend a lot of time and energy, seldom can digest the amount of performance information that governments produce.
- **Media:** It is generally assumed that the media plays an important watchdog role on behalf of the public with respect to government performance. Many of the reasons reflect challenges the media face in a changing world, but also its culture.
    - **Topicality:** Performance information and financial reporting are universal in their coverage of a government's activities. The media focus on the topical and specific. Even when reporting on the release of such reports, media will relate it to high interest topics of the moment.
    - **Limited resources:** The media simply cannot, for the most part, devote the time it will take to really do an in-depth analysis. This challenges governments to create more user-usable information.
    - **Lack of confidence:** Media culture is inherently distrustful of government. In receiving reports, the question likely to be asked is "What are they not telling us?" rather than "What is this telling us?" It is also for this reason that the media, like both legislators and citizens, will pay more attention to reports by auditors general than the government itself.
    - **Abstractness:** The media find reports too abstract and generalized. The key media focus is about the impact on individuals.

None of this is intended to discourage good reporting. It is basic to both the internal needs of government and its democratic responsibilities. However, in designing such information, these considerations do matter. The bottom line has two threads:

1. Financial statements need to meet the highest standards, not be subject to restatements or errors and have the backing of the auditor providing the opinion. There is little room for flexibility in reporting.
2. Performance information has to be meet two tests:
    - For internal purposes, it must be timely, relevant and useful to the managers and others using it.
    - For external reporting, it must strive to be useful to a range of users, often finding ways to communicate information with the end-user in mind.

Chapter 11
External Reporting: Financial Statements

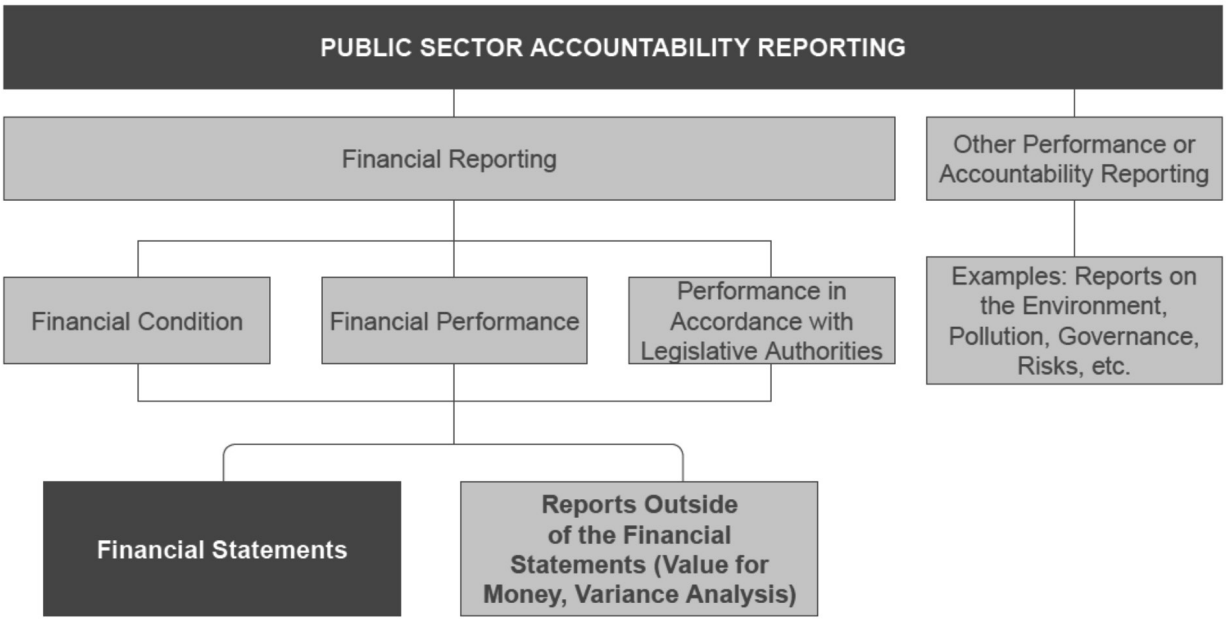
Financial Statements – A General Overview

This chapter deals with the GAAP compliant formal financial reports of governments. Providing accurate financial statements that stand up to audit is essential to sound financial reporting. As we have already seen, governments go to great lengths to secure that credibility. This chapter should be read in conjunction with **Chapter 3, The Accounting Framework.** Only where necessary will the definitions found there be repeated. This chapter will only deal with the final financial statements and not the internal mechanisms of journal entries and financial systems that generate them.

While the focus of financial statements is to meet external accountability requirements, they are certainly of use internally to governments for both management and accountability. Therefore, the distinction between this and the next chapter is based on the nature of the matters being reported. Here we focus on PSAB standards for financial reports. In the next we focus on non-PSAB reporting, which is more focused on program results rather than financial ones. Of course, as discussed in the last chapter, both fit within the overall reporting framework and are linked. Financial statements as outlined here are audited financial statements, subject both to the standards already referenced and an independent audit review. The statements themselves offer management's best efforts to present financial performance. An independent audit by an independent auditor, be it an auditor general or an audit firm, gives greater assurance that the statements are free of material misstatement and that they conform to the accounting standards that apply. The ideal state is for that independent auditor to provide an unqualified opinion based on standards. Government may direct organizations to use a different method for certain purposes. For instance, many First Nations, using the PSAB accounting framework also direct that intangibles such as fishing licences, be recognized in statements. This will give rise to a qualified opinion from the independent auditor. The key here is that the opinion is about the deviance from the standards, not whether it is right or wrong. The other side of the independent audit that is important is an assurance that, based on the audit, the information is free of material error and fairly represents the financial position and performance of the government.

Canadian Public-Sector Financial Management, 3rd. Edition, by Andrew Graham. Montréal and Kingston: McGill-Queen's University Press, Queen's Policy Studies Series. © 2019 The School of Policy Studies, Queen's University at Kingston. All rights reserved.

Figure 11.1
Structure of Government Financial Reporting


PUBLIC SECTOR ACCOUNTABILITY REPORTING
Financial Reporting
Other Performance or Accountability Reporting
Financial Condition
Financial Performance
Performance in Accordance with Legislative Authorities
Examples: Reports on the Environment, Pollution, Governance, Risks, etc.
Financial Statements
Reports Outside of the Financial Statements (Value for Money, Variance Analysis)

Source: PSAB, A Revised Conceptual Framework for the Canadian Public Sector, Consultation Draft, May, 2018

In determining where financial statements fit into the overall picture of management and accountability within the public sector, the PSAB offers the useful outline in **Figure 11.1** on the next page. What is important about this diagram is how central financial reports are to both financial and managerial reporting. Further, since they are used in many different ways, their validity becomes a touchstone for governmental performance as a whole.

Financial statements report on financial conditions and financial performance. They do not report on matters of effective governance, non-financial performance and sustainability, except in terms of liquidity. We also have to remember that financial statements, on their own, only report on the financial effects of past transactions. They do not present performance information that cannot be monetized, but that is still vital to an understanding of the overall effectiveness and health position of a program, organization or government. They do not provide information on the timeliness of infrastructure renewal, quality of program or impact on intended groups. This is done either through the Management Discussion and Analysis (MDA), which are part of the overall financial statement package or in separate performance reports to be discussed in the next chapter. While the statements themselves do not explain changes in the program environment, major economic and natural upheavals, or sudden policy shifts, they reflect it. It takes the MDA and the notes to bring in such context, or a cross-reference to other performance information. In many governments, an annual report will do just such an integration of context, performance and financial statements.

Financial statements perform three tasks, which will further be elaborated under their objectives:

1. Report on financial position
2. Report on financial performance, and
3. Assure that the entity performed in accordance with its legislative authorities such as the legislatively approved budget.

According to the PSAB, the objectives or results that the financial statements aid to achieve are to:

1. **Define scope:** Financial statements should provide an accounting of the full nature and extent of the financial affairs and economic resources that an entity controls and the economic obligations it must settle, including those of its components and controlled organizations.
2. **Report financial position:** Financial statements should present the entity's financial position at the end of the accounting period. This means reporting on assets and liabilities and economic resources

available for future use, contrasted with comparable information at the beginning of the period. A full understanding of the entity's financial position including its net debt or surplus will provide important information to the user on the entity's or program's sustainability at the end of the accounting period.

3. **Report changes in financial position:** Financial statements should present information to describe the changes in the entity's financial position in the accounting period. This should include how it's spent its allotted funds and changes in revenue. They must report on activities during the accounting period.
4. **Compare actual performance to budgeted:** The comparison of actual financial performance against the budget is a fundamental component of financial accountability in the public sector. Actual-to-budget comparison provided in the financial statements forms the basis for closing the accountability cycle. It is crucial for users to compare what was budgeted to what actually happened.
5. **Report non-compliance with legislative authorities:** Financial statements should provide sufficient information for users to determine if the resources provided to the entity were administered in accordance with legislative authorities.
6. **Report risks and uncertainties:** Information should be provided about risks and uncertainties that could affect financial performance, either retrospectively or prospectively.[1]

Building Blocks of Financial Statements

There are the only economic phenomena that are to be reported when reporting either financial position or performance. As defined in Chapter 3, the first two are:

- **Assets**: Assets are resources owned, or in some cases controlled, by an individual or organization as a result of transactions or events from which future economic benefits are expected to flow to that individual or organization. In recording assets, three elements are needed:
    - The entity has control of the resource.
    - The economic event has already occurred.
    - They provide economic benefits that enable the entity to provide goods and services, future cash inflows or reduce future cash outflows.
- **Liabilities:** Liabilities are legal financial obligations the organization has arising from past transactions or events. They are claims against the assets of the organization. Alternatively stated in the IFRS, "A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise or resources embodying economic benefits."[2] Key characteristics are:
    - They involve a responsibility to others with little discretion to not pay.
    - There is a responsibility to settle by future transfer or use of economic resources.
    - The event that created the obligation has already occurred.

Add to these:

- **Revenues:** Revenues are an increase in assets or a decrease in liabilities in the accounting period that results in an increase in net assets or a decrease in net liabilities. In the public sector context, examples of revenue are taxation, fines, transfers, sale of goods, rendering of chargeable services, grants.
- **Expenses:** An expense is a decrease in assets or an increase in liabilities in the accounting period that results in a decrease in net assets or an increase in net liabilities. Examples of expenses are provision of services (salaries, associated costs), production of goods amortization of tangible capital assets, rent payment, financing costs.

Consistent with the outline in Chapter 3, but with the addition of the contextual MDA and notes, complete set of financial statements for any public entity, based on the *Public Sector Accounting Standards,* includes all of the following components:

1. Management discussion and analysis (MDA), which outlines managerial responsibilities for the preparation of the report as well as the signatures of those designated responsible for them
2. Independent auditor's report, which provides an attestation that the information conforms with established accounting practices
3. Consolidated statement of financial position
4. Consolidated statement of operations
5. Consolidated statement of changes in net assets/debt
6. Consolidated statement of cash flows

1. PSAB, "A Revised Conceptual Framework for the Canadian Public Sector, Consultation Draft," May, 2018. This list is an adaptation of Chapter 3: Financial Reporting Objectives.

2. Ibid. p. 49, IFRS.

7. Notes to the statements.[3]

These components are referred to by a variety of names. A good description of such statements can be found, for the Government of Canada for example, in **Figure 11.2**. The statement of financial position may also be referred to as a balance sheet or statement of assets and liabilities. The statement of operations may also be referred to as a statement of revenues and expenses, an income statement, an operating statement, or a statement of surplus or deficit. The notes to the financial statements may include items referred to as "schedules" in some jurisdictions. One cannot fully understand financial statements without the explanatory notes. In fact, these notes are an integral part of the financial statements.

The term *consolidated financial statements* is an integration of all the above reports. As such, it is a set of reports in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. The statements are often at a government or departmental level. They will bring together all the entities within their reporting universe. Many of these units will produce their own financial reports, especially government business enterprises, Crown corporations, and arm's-length entities that remain part of the government or department. All of these various reports have to reconcile and cross-check, which keeps financial people busy. However, if the user wants what is called a whole-of-government view, then the consolidated financial statement is what is needed. However, if the user needs to drill down in more detail, then the specific individual reports are beneficial. One thing is certain: consolidated financial statements must, in the MDA/notes, be very clear about how the entity they report upon is defined, i.e., what is inside and what is outside the entity. In some instances, the notes will provide additional information on the financial performance of the unit or entity included in the whole-of-government entity.

3. Ibid.

Figure 11.2
Government of Canada Financial Statements

The first is the Statement of Operations and Accumulated Deficit, which presents the Government's revenues, expenses and surplus for the year, and the net accumulation of the annual surpluses and deficits since Confederation.

The second is the Statement of Financial Position, which discloses the Government's cash balances and investments, amounts owing to and by the Government at the end of the year, and the Government's non-financial assets such as its tangible capital assets and inventories. It also presents both the accumulated deficit of the Government and its net debt, which is the difference between the Government's total liabilities and its financial assets.

The third is the Statement of Change in Net Debt, which explains the difference between the Government's annual surplus and the change in the net debt for the year. It reports the extent to which revenues recognized in the year were sufficient to offset expenditures, as opposed to the expenses recognized in the annual surplus. In that regard, it is an important flow financial statement, one that shows changes over a specified period. This is seen as important as the part of the Statement of Operations called Net Worth is actually a stock statement, one that reflects the state of overall worth at one point in time.
The fourth is the Statement of Cash Flow, which provides information on the Government's cash provided by or used for operating, capital, investing and financing activities.

Source: Public Accounts of the Government of Canada.

Management Discussion and Analysis

Financial statements themselves do not provide a full picture of the context for reviewing them. This is provided in the Management Discussion and Analysis (MDA) and the notes. They are an essential part of financial documentation and should be studied when coming to an understanding of the full meaning of financial statements.

> The purpose of the Management Discussion and Analysis is to provide a means for government management officials to discuss what the financial statement numbers mean (financial information), what was accomplished during the reporting periods (performance information), and the organization's systems, controls and legal compliance (governance information).[4]

The point of adding a textual portion to the overall financial and performance data is that such information tells the story about what happened to the organization in a

4. "Accounting Standards Framework Implementation Guide for SAIs: Management Discussion and Analysis of Financial, Performance and Other Information," issued by the Committee on Accounting Standards, October 2001.

given period. The role of the MDA is to explain why the results or changes came about as they did. Without this, a full understanding of the financial data is not possible.

The PSAB, in its guidance to public-sector organizations, outlines the following principles for MDA material accompanying financial statements. This material should

- Enable readers to view the organization through the eyes of management
- Complement as well as supplement financial statements
- Be reliable, complete, fair, and balanced, and provide material information
- Have a forward-looking orientation
- Focus on management's strategy for generating value over time
- Be written in plain language, with candour and without exaggeration, and embody the qualities of understandability, relevance, comparability, and consistency over reporting periods.[5]

Increasingly, the MDA will be integrated into an annual report that encompasses both a narrative, explanations of performance, a forward orientation along with the financial statements.

The following general categories would be part of an MDA:

- Mission and organizational structure information
- mission
- major programs, functions, and activities
- organization structure
- operating environment
- Financial information
- financial highlights
- financial condition
- sources of financing – taxes and other receipts
- financing provided by debt and debt management
- Performance information
- results and achievements
- expectations
- costs versus results
- Governance information
- systems and controls
- changes in accounting procedures
- compliance with legal requirements
- comparison of budget to actual
- Forward-looking information
- major changes in policy
- risk factors taken into consideration

The Statement of Financial Position or Balance Sheet

The statement of financial position reports on the resources controlled by the organization and the ways in which they are financed, providing a snapshot of the financial position of the organization at a specific point in time. It describes the worth of the entity at a specific date. This may be at the end of a quarter or a fiscal year. It is, in essence, a snap shot. The balance sheet does not record flows of cash and resources, merely the results of those flows. It is recorded at one point in time. It includes all resources, regardless of how accessible they are for current use. This report focuses on the worth of the organization. We will look at three statements of financial position to see their variety, but also how the form works.

The first is the Consolidated Statement of Financial Position of the City of Oshawa, provided in **Figure 11.3** on the next page.

The second is from the Dene Tha' First Nation of Alberta, to be found in **Figure 11.4.**

A third, for a small not-for-profit organization, is shown in **Figure 11.5**. Hope for Street Kids is an urban non-profit organization that helps homeless kids through counselling and liaison with schools and social agencies. It operates for the most part with volunteers and one staff member but has good financial support from the community. The period ending November 30, 2018, has been chosen because it is the end of the first quarter of this organization, which began its fiscal year on September 1, 2018.

The first point to remember about balance sheets is that they are, as noted, simply snapshots. They do not report flows of cash. Further, a table like this would normally be accompanied by notes explaining the various elements. For instance, to understand the Net Assets portion, it is necessary first to understand what makes up the Restricted Fund and the relative liquidity of the Unrestricted Fund.

"Reading the Balance Sheet"

There is an element of reading all financial reports that is strictly intuitive. That is what is called being able to "read a balance sheet," a common way of describing the skill of analyzing numbers, setting them in context, and identifying elements of importance. This helps the reader form a general picture of the overall health of the entity

5. CICA, *Not-for-profit Financial Reporting Guide.*

… continued on page 222

Figure 11.3
Consolidated Statement of Financial Position: City of Oshawa

The Corporation of the City of Oshawa
Consolidated Statement of Financial Position
December 31, 2016

	2016	2015
Financial Assets	**$**	**$**
Cash and cash equivalents	56,017,800	50,439,122
Short-term investments	71,454,700	58,992,528
Taxes receivable	5,549,200	6,500,546
Accounts receivable	10,811,268	5,872,534
Other assets	101,500	101,500
Investment in Oshawa Power and Utilities Corporation (Note 3)	56,348,400	51,918,400
	200,282,868	173,824,630
Liabilities		
Accounts payable and accrued liabilities	24,955,949	26,919,503
Deferred revenue (Note 4)	61,420,674	55,266,546
Employee future benefits and other liabilities (Note 5)	50,555,954	49,525,931
Long-term liabilities (Note 6)	87,399,129	82,599,594
Liability for contaminated sites (Note 7)	3,050,000	3,050,000
	227,381,706	217,361,574
Net Financial Debt	(27,098,838)	(43,536,944)
Non-Financial Assets		
Tangible Capital Assets (Note 9)	582,853,140	575,305,002
Inventory and prepaid expenses	2,972,901	2,822,861
Accumulated Surplus (Note 10)	558,727,203	534,590,919

Figure 11.4
Consolidated Statement of Financial Position, Dene Tha' First Nation

Dene Tha' First Nation
Consolidated Statement of Financial Position
As at March 31, 2015

	2015	2014
Financial assets		
Cash and cash equivalents	**2,119,182**	1,091,267
Due from Government of Canada (Note 3)	**261,700**	788,850
Accounts receivable	**1,682,738**	1,707,996
Guaranteed investment certificates (Note 5)	**190,699**	113,439
Investment in First Nation business entities (Note 6)	**12,891,440**	5,495,781
Total financial assets	**23,230,161**	26,959,222
Liabilities		
Accounts payable and accruals	**2,263,678**	2,230,517
Deferred revenue (Note 8)	**1,659,927**	1,346,741
Long-term debt (Note 9)	**1,451,504**	1,563,800
Total liabilities	**5,375,109**	5,141,058
Net financial assets	**17,855,052**	21,818,164
Contingencies (Note 10)		
Non-financial assets		
Tangible capital assets (Note 11) (Schedule 1)	**62,466,565**	66,493,024
Prepaid expenses and deposits	**5,841**	80,741
Total non-financial assets	**62,472,406**	66,573,765
Accumulated surplus (Note 12)	**80,327,458**	88,391,929

Figure 11.5
Statement of Financial Position for Hope for Street Kids

Hope for Street Kids
Statement of Financial Position
November 30, 2018

Assets		**Liabilities**	
Current Assets		**Current Liabilities**	
Cash	10,000	Accounts Payable	40,000
Accounts Receivable	20,000	Accrued Wages	10,000
Inventory	50,000	Total Current Liabilities	50,000
Total Current Assets		**Long-Term Liabilities**	
Fixed Assets		Bonds payable	200,000
Equipment	250,000	Mortgage payable	150,000
Building	150,000	**Total Long-Term Liabilities**	350,000
Land	110,000		
Total Fixed Assets	510,000	**Net Assets**	
		Restricted Fund (Perm)	100,000
		Unrestricted Fund	40,000
		Reserve	50,000
		Total Net Assets	190,000
Total Assets	**590,000**	**Total Liabilities**	**590,000**

and also the risks. As one reads this statement, the notes are invaluable in providing context. In each of these examples, there are extensive notes also available, much more in the two governments' reports. Space does not permit including them in the text.

The City of Oshawa provides a fairly normal kind of report for a municipality. In reading them, there is not a great deal to cause concern. It is of interest to note a healthy increase in assets, most notably in Cash and Accounts Receivable. These are funds owed to the city. A reader might look in the notes for a more detailed report on these. In this instance, there is not additional information. Note the large Tangible Assets number. This reflects the fact that municipalities own and operate a significant proportion of public sector infrastructure in Canada. Overall, a reading of the statement is position.

The Dene Th'a First Nation statement follows accepted financial standards and has received a positive audit representation. A quick look at the ratio of assets to liabilities would suggest a very good liquidity position. This is known as the Quick Ratio, which will be discussed in Chapter 12. However, note that the basis of calculation must take out of consideration the funds invested in First Nations business enterprises and funds held in trust, neither of which can be considered readily available. Once again, the notes come to the rescue. For investments, the notes outline the wholly-owned businesses and partnerships in which the First Nation is an owner or partner. The Note also provides a modified statement of financial position for each of the business entities. Note 7 explains that the funds held in trust are actually held by the Government of Canada as part of its legislative responsibility to transfer funds to First Nations, but subject to the audit oversight of the auditor general of Canada. In addition, part of the funds held in trust include a Settlement Trust, created as a result of an agreement between the First Nation and Canada related to the Mackenzie Valley Pipeline.

The Hope for Street Kids appears to be fairly well-resourced as it has built up retained earnings over the years. At least, it is holding reserves and funds in Net Assets that are disproportionate to the staff levels, which can be deduced from the amount of Wages Accrued. It might also be assumed that there are very few paid staff but many volunteers. Otherwise, the physical plant would not be necessary. There is very little to tell us what HSK does in terms of helping street kids and very little program information. That is normal. Financial reports would generally be incorporated into external reporting with program information. It is of interest to note when combining this with the statement of operations in **Figure 3.13** that its rate of spending is at a deficit level, which it can cover, but not forever.

The Statement of Operations

This financial statement has many names:

- Statement of surplus and deficit
- Income statement
- Operating statement
- Activity statement
- Statement of revenues and expenditures

Unlike the statement of financial condition, which is a snapshot on a given day, the statement of operations covers the financial transactions of the organization for a given period of time – a month, a quarter, a year. This report sets out the details of the organization's revenues and expenses for the period. It also gives information about the changes in its economic resources and obligations as a result of its activities. The focus for public-sector organizations is that the report should accurately describe the delivery costs for the organization and the extent to which those costs were covered by the approved budget, inflowing fees or contributions or other revenue. As these reports are now based on accrual accounting, they will also consider the depreciation incurred during the period being reported upon.

Organizations may use a number of different ways to group together or categorize their revenues and expenses in the statement of operations:

- By object: salaries, benefits, rentals, cost of services
- By function: research, client service, inspection, support, or administrative services, etc.
- By program: operations unit, administration unit, etc.

Where organizations operate different programs that they want to distinguish, it is possible for the statement to be organized along functional or program lines with a further breakdown using common objects. This will provide greater detail. **Figure 11.6** offers a simple activity statement for HSK.

Figure 11.6
Statement of Operations

Hope for Street Kids
Statement of Operations
First Quarter, ending November 30, 2018

	2018	2017
Revenues		
Total	29,800	38,300
Expenses		
Total	36000	41200
Increase (Decrease) in Net Assets	(6200)	(2900)

This is about as basic as it can get. Even for a small operation such as this, it is hardly adequate. It is reasonable in this situation for the Board or CEO to ask for a more detailed report, one that provides material and relevant information. A more complex version of this statement would provide more information. The organization of this information, and what is included in it, are matters of discretion for the reporting entity. A statement of operations for HSK that provides further detail would look like this.

Figure 11.7
Detailed Statement of Operations

	2018	**2017**
Revenues		
Government grants – program specific	17500	15000
Grants – general	0	2000
Non-governmental contributions – specific/restricted	4000	7500
Unrestricted contributions	6000	10000
Fees	0	1000
Interest	2300	2800
Total	**29,800**	**38,300**
Expenses		
Salaries and benefits	10000	10000
Rentals, equipment	2000	2200
Supplies	5000	6000
Aid to Kinds: program, financial assistance, travel home	19000	23000
Total	**36000**	**41200**
Increase (Decrease) in Net Assets	**(6200)**	**(2900)**

"Reading the Statement of Operations"

The most notable feature of this report is that HSK is currently operating in a deficit position, and it is persistent. This does not mean that it does not have the resources to cover a deficit or that it is operating inappropriately. From the statement of financial position in **Figure 11.5**, it is clear that this organization has a good supply of net assets in all forms. The statement of financial position indicates that it has been successful in raising money and could readily dip into its reserve fund of $50,000 to cover its deficit. Notes to the statement should indicate that this is happening, if that is the course of action the organization has chosen to pursue.

While HSK is a small organization, it appears to have a number of funding sources: government funds for specific purposes (restricted), government funds with no restriction, contributions for specific purposes (restricted), and general donations with no restriction on their use. In fact, aside from some standard expenses like salaries and supplies, all other expenses are for one program object: aid to kids. This report, while accurate, does not help certain users sort out if the funds are being spent for the intended purposes or exactly how needs are being met. For instance, from **Figure 11.7**, it would appear that HSK has three lines of activity:[6]

- Program grants to organizations and individuals to provide counselling services to street kids
- Short-term financial aid given directly to kids, and
- Funds to help kids return to their hometowns.

An additional table, such as **Figure 11.8**, would provide greater clarity as to the distribution of resources. Organizations will often put much more detailed information in the notes. Similarly, given the relatively uncomplicated chart of accounts, this information could readily be found in the financial statements themselves.

6. In large organizations, even in the public sector, these would be called business lines.

Figure 11.8
Line Item Distribution

Hope for Street Kids
Statement of Operations – Supplement in Notes
Line Item Distribution of Aid to Kids
For the period ending 30 November 2018 (First Quarter)

	2018	2017
Program activities: grants to counselling services	11,000	13,000
Short-term financial assistance	6,000	5,500
Travel assistance – kids to their homes	2,000	4,500
Total	**19,000**	**23,000**

Looking at the City of Oshawa, a much larger public-sector organization, one finds many more matters of interest. In the statement of operations (**Figure 11.9**), on the next page, the reader will find much of interest.

There has been an increase in property tax revenues, which could be attributed to more development, market changes in the value of houses or the result of a tax rate increase approved in the budget. User shares are down, but still higher than the budget projection. Note that expenses are listed by function – the program area in which they are spent. General government is a catch-all for general administration. The referenced Note in this instance, breaks down the expenses by object. An object is the type of expenses, such as salaries, interest, material and supplies and amortization. **Figure 11.10** shows this Note and is a good example of an explanation for what the expenses paid for. The main statement structure shows their program purpose.

Figure 11.10
Statement of Operations, City of Oshawa, Expenses by Object (Note 13)

Expenses by Object
The following is a summary of the expenses reported on the Consolidated Statement of Operations by object of expenses

	2016	2015
Salaries, wages and benefits	$90,152,022	$90,423,539
Interest on long-term debt	3,398,246	3,593,784
Materials and supplies	47,217,379	44,942,075
Rents and financial expenses	206,558	171,856
Transfer payments	4,224,816	4,155,733
Amortization	26,429,175	25,661,386
Total	**$171,628,196**	**$168,948,373**

Neither of these examples lists elements that may appear on the expenditure side of the equation: bad debts and depreciation. Bad debts are amounts owed to the organization but have not been collected and that the organization realizes it will never collect or that it will cost more to collect than the total of the debt. In general, organizations will set a time limit on how long an accounts receivable item can be left on the books before it is declared a bad debt and written off as a charge. That is assuming that the organization is taking reasonable measures to collect its receivables in the meantime. Organizations want to remove these bad debts from their books of accounts receivable, so they write them off and report it as an expense in the statement.

Another element that will be found in the statement of operations is depreciation. This is treated as an expense. All tangible assets must be depreciated and listed as an expense. This represents the amount of the asset that has been consumed in the reporting period. Two most common ways of calculating depreciation are the straight-line method and accelerated or declining-balance depreciation, which assumes a preference to charge more depreciation in the early years of the use of the item and less in the later years when there will be more maintenance costs to offset the lower depreciation costs.

The statement of operations offers current information on expenses and revenues. For operating managers and those engaged in financial support activities, this is a valuable

… continued on page 226

Figure 11.9
Statement of Operations, City of Oshawa

The Corporation of the City of Oshawa
Consolidated Statement of Operations
year ended December 31, 2016

	Budget (Note 17)	2016	2015
	$	$	$
Revenues			
Property taxation	123,934,044	127,499,714	121,230,919
Taxation from other governments	3,669,500	3,456,285	2,808481
User charges	18,959,001	20,082,019	23,452,220
Government grants	1,011,731	640,662	999,480
Contributions from developers – earned	1,660,750	1,575,251	2,662,355
Revenue recognized on assumed assets	8,253,700	8,253,708	9,000,425
Federal gas tax revenue	4,529,010	4,529,010	3,024,333
Investment income	1,843,600	2,329,883	1,667,104
Penalties and interest on taxes	1,213,100	1,322,614	1,213,007
Licenses and permits	3,172,900	6,456,741	4,416,118
Fines	1,122,040	1,059,158	1,138,874
Net earnings Oshawa Power and Utilities Corporation (Note 3)	1,235,000	6,330,000	3,906,000
Other	13,588,775	12,229,435	8,363,930
	184,193,151	195,764,480	183,883,246
Expenses (Note 13)			
General government	38,892,000	36,625,377	36,759,882
Protection to persons and property	34,166,570	33,840,480	31,263,371
Transportation services	37,359,773	32,552,115	32,124,053
Environmental services	6,680,344	7,278,169	6,120,627
Health services	227,267	515,283	526,551
Social and family services	1,678,300	1,700,876	1,681,068
Social housing	209,490	234,925	229,977
Recreation and cultural services	50,755,595	54,112,016	55,590,624
Planning ad development services	5,316,786	4,768,955	4,625,220
	175,286,125	171,628,196	168,948,373
Annual Surplus	8,907,026	24,136,284	14,934,873
Accumulated surplus, beginning of year	534,590,919	534,590,919	519,656,046
Accumulated surplus, end of year	543,497,945	558,727,203	534,590,919

picture of the present state of liquidity and whether the organization is on target relative to its budget. That is why you will see a column with the budget for the year under review. In addition, providing information on the previous year's performance is important. It enables the reader to quickly see if there is any change year-to-year. These are important elements of in-year budget management.

Statement of Changes in Net Assets or Net Debt

The accumulated debt – or surplus – of a government is of interest to the public in general and often seen as an indicator of fiscal prudence. An important financial ratio often used in assessing government performance is the ratio of net debt to GDP, based on the theory that there is a limit to how much the cost of debt can be sustained while retaining a healthy economic condition. The statement describes the extent to which expenditures for the accounting period are met with the revenues for the same period. It also highlights how the government's expenditures were financed. Net debt rises when revenue is insufficient to cover expenditures. It details the changes in the government's net assets during the reporting period, usually a year. It shows the degree to which the organization's operations have added to, or depleted, its net assets or net debt. This statement identifies the sources from which additional funds or cash were derived and the uses to which these funds were allocated.

The statement of changes in net assets or net debt reconciles the change in net debt for the current and the prior year. To explain how the expenditures of the period were met by revenues, the statement reconciles the annual operating surplus or deficit shown in the statement of operations, which includes revenues and expenses, to the change in net debt. Factored in at this point are items that explain the difference between the surplus/deficit reported in the statement of operations such as the acquisition or disposal of tangible assets, current year amortization for tangible capital assets, and the acquisition or disposal of non-financial assets.

The statement of changes in net assets reconciles the organization's net assets position as reported in the statement of financial position at the beginning and end of the reporting period. This clearly identifies the resources available to the organization for future activities.

Returning to the City of Oshawa, **Figure 11.11, Statement of Change in Net Debt** provides a good picture of the changes over the year that led to its current debt situation. Note the impact of intangible assets on the debt situation. This is normal in such circumstances as capital acquisition is a major preoccupation of municipal governments.

Figure 11.11
Statement of Change in Net Debt, City of Oshawa

The Corporation of the City of Oshawa
Consolidated Statement of Change in Net Debt
year ended December 31, 2016

	2016	2015
	$	$
Annual Surplus	24,136,284	14,934,873
Amortization of tangible capital assets	26,429,175	25,661,386
Acquisition of tangible capital assets net of transfers from Work-in-Progress	(35,159,987)	(26,091,309)
Loss on disposal/write down of tangible capital assets	1,182,674	3,168
Change in inventory and prepaid expenses	(150,040)	(248,545)
Decrease in net debt	16,438,106	14,259,573
Net debt, beginning of year	(45,536,944)	(57,796,517)
Net debt, end of year	**(27,098,838)**	**(43,536,944)**

Figure 11.12 provides the 2018 Statement of Change in Net Debt for the federal government of Canada. This is an important part of the financial reporting for this government, given the macro-economic impact of its debt. Note that the year begins in deficit. Note as well that some numbers from 2017 were restated. A restatement is the revision of a previous financial statement to make it more accurate. This can arise when there is a need to correct an error, there are changes in accounting rules that require the government to restate previous year's statements to permit year-to-year comparisons, or when there are changes in the reporting entity. In this instance, the notes reveal that the restatements were made as a result of changes in the discount rate methodology, requiring the recalculation of depreciation values.

Statement of Cash Flows

The statement of cash flows provides information on the changes in cash and cash equivalents from one reporting period to the next. It provides information on sources of cash and the overall dependence on debt, as outlined in the statement of net debt. While the statement of cash flows cannot tell the user how the entity is performing against

Figure 11.12
Statement of Change in Net Debt, Government of Canada, Year Ending March 31, 2018

Government of Canada
Consolidated Statement of Change in Net Debt for the year ended March 31, 2018

(in millions of dollars)

	2018		2017
	Budget (Note 3d)	Actual	Actual Restated (Note 2a)
Net debt at beginning of year	(734,098)	(734,098)	(712,205)
Change in net debt during the year			
Annual deficit	(25,983) 2	(18,961)	(18,957)
Changes due to tangible capital assets			
Acquisition of tangible capital assets	(8,056)	(9,793)	(8,547)
Amortization of tangible capital assets	5,954	5,261	5,168
Proceeds from disposal of tangible capital assets	975	266	421
Net loss (gain) on disposal of tangible capital assets, including adjustments	–	107	(880)
Total change due to tangible capital assets	(1,127)	(4,159)	(3,838)
Change due to inventories	–	163	379
Change due to prepaid expenses and other	–	(955)	(1,334)
Net increase in net debt due to operations	(27,110)	(23,912)	(23,750)
Other comprehensive (loss) income (Note 5 and Note 14)	–	(753)	1,857
Net increase in net debt	(27,110)	(24,665)	(21,893)
Net debt at end of year	(761,208)	(758,763)	(734,098)

The dash means that the amount is 0 or is rounded to 0.
The accompanying notes are an integral part of these consolidated statements.
Details can be found in other sections (unaudited) of this volume.

2 Budget 2017 disclosed the budgetary deficit as $25.5 billion before deducting the adjustment for risk ($3 billion).

budget, it does provide useful information about viability and the presence of cash as needed.

Thus, this statement focuses on cash transactions as opposed to such non-cash items as depreciation and amortization. This statement gives information about the current financial viability of the operation. The statement reports on:

- Cash inflows and their source
- Individual and material cash expenditures over the reporting period, and
- Cash balance at the end of the period.

Failure to adequately manage the cash flow of a government or entity within it that is fully cash dependent may result in negative cash balances or late payments. While the entity may have recognized revenue based on either anticipated transfer from other governments or money owed due to fees billed but not received, its actual cash position may be different from that which is reported on its statement of financial position.

Cash flow statements typically report on the following categories of financial information:

- **Cash flows from operations:** This will include all cash receipts – taxes, fees, pledges, and contributions – and disbursements resulting from the main service-delivery activities of the organization.
- **Cash flows from capital activities:** This category is unique to the public sector, given the significance of capital acquisition and repair.

- **Cash flows from investing activities:** This includes cash outflows related to the purchase of capital assets and the purchase of investments and cash received from the disposal of assets of a similar kind.
- **Cash flows from financing activities:** This includes cash used to pay for prior financial obligations and the acquisition of debt through bonds, loans, treasury bills, etc.

The City of Oshawa provides a good example of a statement of cash flows in **Figure 11.13** on the next page.

Having information on cash flows is very useful in assessing the financial health of a government or reporting entity within it. Generally, this report will enable the user to:

- Determine future cash requirements
- Assess the ability to generate necessary cash flows in the current fiscal year, and
- Determine the ability of the entity to fund future activities or changes.

Summing Up

The financial statements of governments have to be read in an integrated way. Multiple reports are needed in order to provide a full picture so that external users can understand the organization's financial situation. Similarly, some managers will focus on certain elements of the statements and ignore others. Being able to pull useful information out of such statements means being able to "read the balance sheet," a skill that is often referred to when describing financially literate managers. This is a skill bred from experience and from seeking good financial advice. It is also based on the manager's appreciation of the reality behind such numbers. That means understanding the nature of the organization in which she works and how it operates. The ability to read a balance sheet is a skill at pulling out financial information, not necessarily operational or future-oriented information, which is built into how the organization works. However, what being able to read a statement of financial position more accurately translates into is being able to quickly assess the overall health of the entity.

Equally important is being able to read the statement of operations. This addresses the flows in the entity, the amount spent on either the main objects or inputs or programs relative to last year and to budget. From an operational perspective, reading this statement provides a means to quickly assess significant variances, major shifts in revenue and expenses and the need to adjust.

There is a difference between financial information on its own and financial information in context. Good financial advisors help managers bridge that gap. Poor ones just throw numbers at you. As already noted, financial reports exist to meet many needs, some internal and some external to the organization, and their structures tend to be similar across organizations, whether they are in the private or public sector. Generally, though, they serve the needs of external accountability and scrutiny first.

Financial information has two main uses: financial and management. These statements are important for both purposes but are most worthwhile from the financial perspective. Financial information for management purposes involves managing the resources in an effective and efficient manner. This encompasses elements of control, effective budgetary and cash management within a budgetary period, and reporting on results, using a combination of financial information such as has just been described and other performance information to provide a full and balanced picture. Thus, a line manager needs financial information that includes, but also goes far beyond, that found in the financial statements we have examined here. Hence, we turn in the next Chapter to performance information.

Figure 11.13
Statement of Cash Flows, City of Oshawa

The Corporation of the City of Oshawa
Consolidated Statement of Cash Flows
year ended December 31, 2016

	2016	2015
	$	$
Operating Activities		
Annual consolidated surplus	24,136,284	14,934,873
Items not involving cash:		
Amortization	26,429,175	25,661,386
Loss on disposal/write down of tangible capital assets	1,182,674	3,168
Assumed assets recognized as revenue	(8,253,708)	(9,000,425)
Net earnings of Oshawa Public Utilities Corporation	(6,330,000	(3,906,000)
Net changing in non-cash working capital:		
Taxes receivable	952,346	(288,497)
Accounts receivable	(4,938,734)	(563,325)
Accounts payable and accrued liabilities	(1,963,554)	1,368,451
Deferred revenue	6,154,128	8,964,293
Employee future benefits and other liabilities	1,030,023	1,742,581
Inventory and prepaid expenses	(150,040)	(248,545)
Cash provided by Operating Activities	38,247,594	38,667,960
Capital Activities		
Acquisition of tangible capital assets	(26,906,279)	(17,090,884)
Financing		
Debenture debt retired	(5,910,465)	(5,699,024)
New debt issued	10,710,000	—
Cash (consumed) provided by Financing Activities	4,799,535	(5,699,024)
Investing		
Net change in short-term investments	(12,462,172)	(19,734,783)
Dividend received from OPUC	1,900,000	1,800,000
Cash consumed by Investing Activities	(10,562,172)	(17,934,783)
Increase (decrease) in cash and cash equivalents	5,578,678	(2,056,731)
Cash and cash equivalents, beginning of year	50,439,122	52,495,853
Cash and cash equivalents, end of year	56,017,800	50,439,122

The accompanying notes are an integral part of these financial statements.

Chapter 12
Performance Reporting

Chapter 10 sets the stage for this chapter. It explains why we need to report and what financial and performance reporting are and how they interact. Chapter 11 explains how formal financial statements fit and how they are guided by external standards. Performance reporting, while increasingly important in government, covers a wide range of means to gather, use and disseminate information about performance. Financial information, but in GAAP format as outlined in Chapter 11 and in non-GAAP financial information for internal management, is clearly central to assessing a government's or agency's performance. What performance information does is to build in an understanding of what are the important variables that contribute to the agency achieving its planned and budgeted goals for internal control purposes and for external accountability, as previously discussed.

In defining performance reporting needs, i.e., what will be reported, internal users will have a number of questions related both to in-year performance but also overall program performance and sustainability:

- Are we on target?
- Where are our risks?
- How are we doing relative to last year, to budget?
- Are we providing the service coverage and quality we need?
- Are key inputs to our productivity (staff, expertise, technology, infrastructure) available and what we need?
- Are we on plan? Are we seeing information that suggest we need to modify that plan?
- Are we managing well? Are individual managers performing well?

External users will have a different set of questions:

- Are you on budget?
- Can you meet your commitments?
- Did we receive our share or entitlement?
- Are you doing what you said you would?
- Are you efficient?
- Are you complying with the laws and rules that govern funds?
- Are you sustainable?

Risks of Poor Reporting and Overcoming Them

Not having the information to manage an organization, or having the wrong or inaccurate information, poses a number of risks. In fact, organizations put themselves in peril if they fail to watch closely the key performance indicators for their operations. They also create great risks of missing potential threats to their mission, operational anomalies that may lead to errors and reputational damage should an inquiry find that this inattention or measurement of the wrong thing meant the agency ignores clear signs of system failure, persistent error or malfeasance.

Some of the risks of poor internal reporting are:

- Compliance failure
- Loss of trust among staff and trust in the information
- Erroneous operating or strategic decisions
- Failure to alert both bureaucratic and political leadership of potential issues
- Budget shortfalls, overspending, loss of money trail
- Biased or misleading performance evaluation and reporting: doing better than actual
- Creation of a "black book" mentality in which informal information systems are created to avoid using official data
- "Whistling past the graveyard" – senior managers ignore performance information willfully to avoid making tough decisions.

Overcoming these risks requires good governance, quality reporting and using a variety of information sources to make sure the organization creates the information it needs and then actually uses it. The organization also needs to gather information from all phases of its program or production cycle. As we will see, this means ensuring it understands its inputs, its processes, its outputs and the

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contribution these make to the public policy outcome they are meant to serve. Such variety of information sources is a sure protection from the emergence of cognitive biases that ignore unpleasant information.

Governance of performance information is not a task on its own. Rather, it is about the overall governance of the organization. Governance involves not just positions and reporting relationship. It addresses the ways in which an organization makes decisions, understands and learns, sets direction, monitors and controls, and acts to execute its strategy. Good governance is also about setting the values and ethical frameworks for how information is measured and used. This is often called the tone at the top and is an important component of a performance-driven culture, rather than one that hears what it wants to hear and ignores warning signs. In some respects, performance information, both financial and program- or performance-based, is the lifeblood of good governance. To overcome the risks that poor information can create, organizations put in place governance processes such as

- Ensuring that the organization has a clear understanding of its purpose, its clients and its legal and programmatic framework
- The establishment of a reporting framework, often supported through specialized units that gather and analyze the information
- Creating and using procedures in a predictable and visible way to monitor financial and non-financial performance against plans, including senior reviews of this information
- Creating a culture that encourages the sharing of information, good or bad, and avoids a negative focus in performance or those providing information about it
- Actually using the information to make decisions.

Qualities of Performance Measurement

In focusing on the use of performance measurement to manage an organization, there are a number of key qualities that the performance measurement scheme has to meet. Useful performance information has to be:

- Understandable to the generalist user not just the expert provider
- Relevant to what you need to measure to determine progress on goals
- Timely to permit reaction and adjustment
- Reliable, credible and accepted over time
- Comparable in terms of other reporting period, benchmarks, targets or goals.

What We Are Measuring: Looking at Types of Performance Measures

As **Figure 12.1** illustrates there are a number of ways to classify performance measures. These parallel the development of policy and programs within government and return as well to the discussion of different forms of budget. These represent the focus of the measures, roughly categorized as:

- **Inputs:** Input measures are an efficiency measure. Inputs are the inputs to production such as salaries, equipment, grants approved. While many will argue that inputs do not inform you much about the overall value of the program, they do provide a key measure of program efficiency as well as one of the main ways to compare performance to plan. The inputs that an organization watches should reflect its understanding of its business model. By that we mean its understanding of what it needs to get its job done. Examples of input measures are:
    - Money spent on equipment
    - Number of employee hours worked
    - Number of applications processed
    - Facility costs
    - Number of full-time employees.
- **Process measures:** Process measures inform the organization how efficiently it is performing its activities. They monitor the relationship between the amount produced, the time it took, the rates of error against the resources used or a benchmark or standard. They cover a wide range of measures that must be tailored to the organization's critical needs. Examples of process measures are:
    - Cases cleared by agent
    - Calls handled per hour
    - Cost per license issues
    - Percentage of wells that meet environment inspection standards
    - Error rate on subsidy applications.
- **Output measures:** Outputs are what the organization actually produces. In public policy terms, there is an implicit assumption that the outputs of a public agency contribute to a public policy objective, usually articulated as an outcome. The challenge for many agencies is that outcomes, as the examples will show,

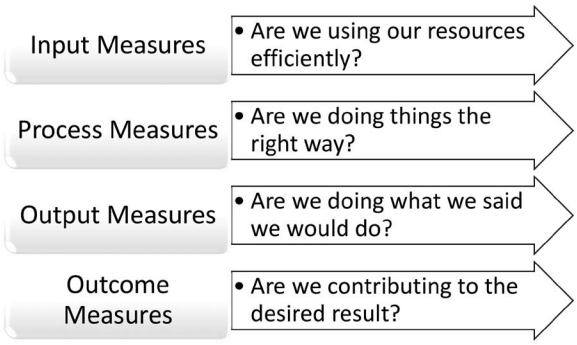
of a public policy may be very broadly defined and engage many agencies and governments in their achievement. Therefore, a clear understanding of the relationship of outputs one agency achieves to the overall outcome is needed. Examples of outputs are:

  - Number of police cases cleared by arrest
  - Number of meals served to homeless people
  - Number of applications cleared and approval rate
  - Number of clients served
  - Kilometers of highway repaved.

- **Outcome measures:** Outcome measures are used to determine the extent to which a core function, goal, activity, product or service (all outputs) have affected the public policy purpose, problem or client group they are intended to serve. While an agency's mission will articulate what that public good is, it will also use the phrase "contribute to" recognizing the complexity of many public policy problems that require multiple agencies acting to effect that public good. Some examples of outcome measures are:

  - Highway accident rates
  - Crime rates and recidivism
  - Homeless rates
  - Drug dependency reduction.

Figure 12.1
Types of Performance Measures


Input Measures
• Are we using our resources efficiently?
Process Measures
• Are we doing things the right way?
Output Measures
• Are we doing what we said we would do?
Outcome Measures
• Are we contributing to the desired result?

Performance Measurement Tools

The variety of ways that organizations measure themselves defies easy categorization. Needless to say, they create the reporting they need or are obliged to have to make internal control effective and assure external accountability. Without claiming to cover the range of measures or measuring tools, this section will examine certain tools that are typically used:

- Historical trends analysis
- Target setting and monitoring
- Benchmarking
- Dashboard of performance indicators
- Use of financial ratios, both generic and specific to government
- Annual reports and citizen-centric reporting.

Historical Trend Analysis

This form of analysis provides information on past performance and compares it to current information. Monitoring results over time is a common tool. It follows the maxim that, all things being equal, organizations will perform in the same way over time. Of course, in the dynamic public sector, this is seldom the case. Therefore, a caution up front: use historical data respectfully, but use it. While this is a simple analytical tool that looks at the measurement result from a number of comparable time periods, it does provide the manager with an important start to determine if current results are going in the planned direction. Historical trend analysis provides a perspective on what could happen to a particular cost or trend, notwithstanding other changes. It can confirm variations in trends over the year that repeat them. For instance, the volume of applications may vary seasonally, a fact confirmed by historical analysis. The other advantage of historical analysis is that it is built on verifiable financial and non-financial information from within the organization.

Target Setting

Targets establish a level of acceptable or approved performance for an agency. They then provide standards against which to compare actual results. Targets can involve costs, timeliness, number of processes completed or error rate tolerance. Targets provide a ready way for agencies to hold their managers to account. Used externally, they give the public an easy way to measure variance in performance and look for actions to adjust or explanations for the variance. Targets have the benefit of clarity. However, they also have certain deficiencies. Much will depend on how

they are set. If the target is arbitrarily set, then it can distort organizational behaviour. One instance that has been well documented is the case of wait times in emergency rooms. Clearing those arriving quickly even without treating them or, as has happened, keeping patients waiting in ambulances rather than admitting them, are forms of distorting behaviour driven by unrealistic targets.

Benchmarking

Benchmarking compares the agency's performance to an external standard derived from research or developed by professional organizations. It has the appeal of providing an external validation of performance with respect to costs, rates of performance and other metrics. Governments can use a number of ways to benchmark. They can compare themselves to other governments doing similar programs. They can adopt standards set by standard-setting organizations representing professional groups. They can benchmark themselves against private sector firms. For instance, they can compare their call centres to private sector ones in terms of length of wait, number of calls cleared, etc. Benchmarking can result from a collaborative effort such as the Ontario Municipal Benchmarking Initiative (OMBI).

The challenge in benchmarking is getting an "apples-to-apples" comparison. The OMBI is a good example of the effort made by the collaborating municipalities to determine how best to benchmark themselves and then to explain to their political masters and the public the reasons for differences. This effort, now in place for many years, illustrates both the benefit and the drawbacks. On the benefit side it has forced the municipalities to develop a deep understanding of the processes being compared, the basis for valid comparison and the basis for differentiation. This clarity has built up a vast knowledge of basic municipal programs and practices. On the negative side, publication of these comparisons, especially cost comparisons, can force a race to the bottom in terms of trying to reduce costs to benchmark against the lowest cost of the service.

Benchmarking is a valuable tool in performance measurement. However, it is only one and is best used with a lot of contextual knowledge of the program. Good benchmarking delivers both a comparative number and an understanding of the underlying factors affecting it. For instance, a national agency may compare travel costs among its regions. There may be great variation. This may be caused by the size of the region and the distribution of its activities. While regions are all doing the same thing, the very territory they serve will affect cost.

Financial Condition Analysis and Financial Ratios

Financial condition analysis (FCA) is an element of how stakeholders and organizations view their financial statements to address such questions as:

- Can the organization meet its overall financial obligations?
- Does the organization have the cash solvency to meet its obligations in a specified period?
- Do the financial statements show that the organization – or government – has the revenue capacity to meet its budget plans, i.e., budget solvency?
- Is the organization solvent over the long-term, i.e., is it sustainable?
- Does the organization have program solvency, i.e., do the funds committed and available provide resources to sustain the current level of program delivery?

FCA consists of three approaches to answering these questions, not unlike the entire measurement framework outlined in Chapter 10:

- **Horizontal analysis:** What are the trends in financial and program performance over time, e.g., overtime expense as a percentage of total salary expenses year-to-year?
- **Vertical analysis:** How is the agency performing within the year, relative to plan, e.g., percentage of salaries expended relative to plan?
- **Ratio analysis:** This is a set of comparisons designed to provide indicators of performance using a common ratio base.

Financial managers in government can ask these questions of their own budgets and use FCA tools to help point to issues. However, increasingly, as governments deliver through arm's-length entities and through transfer payment or contribution agreement tools, they have to ask similar questions of the organizations delivering services on their behalf. Included in this growing range is the oversight function that governments have over the broad public sector such as school boards and healthcare organizations. In high-risk situations, including such major investments as capital projects involving public-private partnerships, governments have to keep a close eye on the financial viability of their partners. Further, governments providing international assistance have legitimate duties to question the financial condition of the recipient country in terms of the use of funds through budget instruments and the capacity to actually deliver on aid commitments.

Using FCA tools, such as financial ratios and attendant analysis, assists in this process. The key objective is to come to a conclusion about the financial condition as reported through its financial statements. As we shall see, however, this entails a mix of numeric analysis combined with contextual understanding. Some of the consequences flowing from this analysis involve important political policy, as well as financial and operational consequences. For example:

- Change in the credit rating for the organization or government
- Requirement for the organization to change its activities to come within budget if budget solvency is not convincingly determined after FCA
- Changes in program structure to establish sustainability. (Think here of the continuing efforts to ensure a pension plan is funded at a sustainable level.)
- Increases in oversight, or even a form of direct supervision, where FCA reveals poor management of resources
- Reconfiguration or renegotiation of third-party agreements to mitigate risk.

Commonly Used Financial Ratios

A series of financial ratios have been developed that provide insight into an organization's financial condition. They address certain key concerns about the financial viability of the agency:

- **Liquidity:** Can the agency or government meet its short-term obligations using the assets it has?
- **Sustainability:** Can programs be maintained over time? Is the current debt profile excessive in terms of its impact on the economy and the ability to sustain an inflow of cash from debt?
- **Flexibility:** Is the agency dependent on revenue or locked into program commitments in a way that it cannot adjust to changing circumstances?
- **Vulnerability:** Is the share of transfer revenue so high that it creates a dependence on those sources?
- **Financial efficiency:** Are resources being used quickly to produce program outcomes and, in some cases, revenue?

These ratios are only as good as the soundness of the accounting information. They seldom provide a good picture on their own. They are signals. However, when used in a consistent manner with a good understanding of the context, they can be powerful first levels of analysis. Further, there are many financial ratios and they can be expanded, depending on the user's need for information and level of detail. Some of the ratios presented here are the most commonly used and most applicable to public-sector use. Certainly, when government managers are dealing with complex arrangements with private-sector firms whose financial condition is an important factor, they are wise to seek advice from those competent in private-sector analysis. In addition, governments have developed some unique public-sector ratios that will be discussed below.

Some of the most commonly used financial ratios are:

Current ratio: This is the simplest and most commonly used measure of an organization's liquidity, i.e., the availability of funds to pay the bills in the short term.

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

While this is a popular ratio, it can also be misleading if left on its own. For example, a high current ratio is not necessarily a positive thing as the organization may be sitting on a great deal of cash and not executing its program. Similarly, the idea that all assets, even if they are liquid, can be dispensed immediately violates the ongoing concern principle.

Quick ratio: Also known as the **acid test ratio** is a liquidity indicator that adds further to the current ratio to include inventory and other current assets. A higher ratio means a more liquid current position.

$$\text{quick ratio} = \frac{\text{cash \& equivalents \& short-term investments \& receivables}}{\text{current liabilities}}$$

Operating ratio: This is one of two ratios that address issues of budgetary viability or solvency. The question here is: has this government or organization sufficient sources of revenue to pay for its planned expenditures?

$$\text{operating ratio} = \frac{\text{total revenues}}{\text{total expenditures}}$$

A higher value of the ratio indicates a more desirable level of budgetary solvency.

Own-source revenue ratio: This is a very important ratio when assessing the degree of dependence that an organization or government may have on revenues over which it has less control. We see many parts of the broader public sector dealing with transfer payments from other

levels of government. This movement of these funds, the clarity about the amounts, and the timeliness of their arrival affect the ability of these entities to project revenues accurately. The first question to ask is: to what extent is the entity dependent on revenues generated from its own sources, rather than intergovernmental transfers, which increases uncertainty and risk. A good example would be First Nations own-source revenues relative to the transfer of dedicated and general funds from the federal government. A clear objective would be to both capture and grow own-source revenues in this instance.

$$\text{own-source revenue ratio} = \frac{\text{own source revenues}}{\text{total revenues}}$$

We now turn to two sample ratios that move off the financial statements alone and start to look at program sustainability and debt.

Net assets per capital: This is one way in which, over time, program solvency can be tracked.

$$\text{net assets per capita} = \frac{\text{total net assets}}{\text{population}}$$

Long-term debt per capita: This ratio, manifest in public discussion of debt in a number of ways, is an important element in determining the viability of public entities to take on more debt or to meet their operating and debt commitments. It can point, for instance, to the possibility that a government may default on its bond payments. It would also be a factor in setting the cost of future borrowing. It can be calculated either as below, or by subtracting cash from the overall debt.

$$\text{net debt per capita} = \frac{\text{total long-term debt}}{\text{population}}$$

Public-Sector-Centric Financial Ratios: Example

Governments, in the financial statements, have begun to provide financial ratios that serve the unique needs of government reporting. There is a focus on debt and its impact on a government's program capacity and the cost of debt. That is why, in this example in **Figure 12.2, Ontario Key Financial Ratios**, there are several debt-based ratios. These ratios are present in the Public Accounts of Ontario.

Figure 12.2
Ontario Key Financial Ratios

Key Financial Ratios — Table 10
as at the end of the fiscal period

		2013–14	2014–15	2015–16	2016–17	2017–18
Sustainability	Net Debt-to-GDP (%)	39.7%	40.6%	40.2%	39.5%	39.0%
	Net Debt to Total Revenue (%)	224.6%	233.5%	225.0%	223.2%	215.0%
	Net Debt per Capita ($)	$ 20,246	$ 21,425	$ 22,017	$ 22,237	$ 22,529
Flexibility	Debt Charges to Total Revenue (%)	9.1%	8.9%	8.5%	8.3%	7.9%
	Own-Source Revenue to GDP (%)	14.4%	14.4%	14.8%	14.6%	15.1%
Vulnerability	Federal Transfers to Total Revenue (%)	18.4%	17.4%	17.0%	17.4%	16.5%
	Foreign Currency Debt to Total Debt (%)	22.9%	20.9%	18.8%	16.7%	17.3%
	Unhedged Foreign Currency Debt (%)	0.5%	0.3%	0.3%	0.2%	0.2%

Notes: 1) Actual results for 2013–14 to 2015–16 used for calculation have been restated to reflect the presentation change for hospitals, school boards and colleges, to classify third-party revenue with government revenue.
2) Actual results for 2013–14 to 2016–17 also reflects a change in accounting treatment for net pension assets of jointly sponsored pension plans.
3) Net debt was restated to reflect prepaid expenses and inventory supplies being reclassified as non-financial assets, as opposed to financial assets in prior years.

Source: The Public Accounts of Ontario, 2017–18

These ratios address the overall economic health of the government and its relationship with the economy as a whole.

The Use and Abuse of Financial Ratios

Financial ratios can be powerful analytical tools. The examples offered here cover the range of public-sector financial management concerns, but do not exhaust the number of available ratios. However, one ratio does not a conclusion make, although unfortunately it can make a headline. Further, it is a signal not a solution. A number of further elements of FCA have to be in place to make them truly as useful as they can be:

- There needs to be some form of period-to-period comparison.
- It pays to be able compare the ratio with some form of norm, standard or common guide.
- Trend analysis is important.
- Consistency in comparison is vital. Changes in accounting policies, transfer agreements, or scope of jurisdiction have to be explained.

Scorecards and Dashboards

Each of these tools for reporting, although there is some distinction in their use, brings together a mix of performance reports, combining financial and performance information to present a fuller picture to either the internal user or the public about how the agency or government as a whole is doing. Although the terms scorecards and dashboards are often used interchangeably and there is some overlap between the two, their purposes are differ-

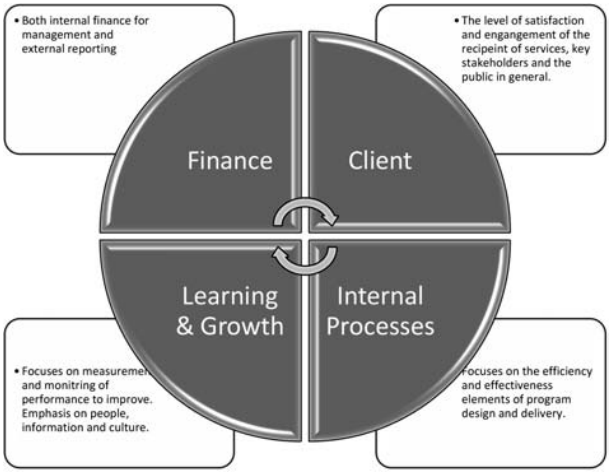
ent. In general, think scorecard for managing strategy and dashboard for monitoring operations.[1]

A scorecard is a way of mapping performance indicators on the agency or government's overall strategy. As such, it will have an outward orientation, designed to inform the public and stakeholders on overall performance. It is not a control mechanism to ensure operational plans are on target. That being said, many governments use the term dashboard rather than scorecard when they are reporting progress either in their annual plan or posted scorecards.

A dashboard provides a more granular view than a scorecard. The primary focus is on internal operations and how objectives are being met. Dashboards are key to effective control in an organization. They are also tools to communicate performance internally.

Both of these represent the effort to have a balanced approach to performance measures, one that includes financial, but also program performance and what are often thought of as the softer side of performance measurement. While various approaches have existed for some time, the work of Harvard professors Kaplan and Norton on balanced scorecards is seminal.[2] In their work, they describe four types of measures that would, taken together, provide a full picture of organizational performance. These are illustrated in **Figure 12.3, Elements of the Balanced Scorecard.**

Figure 12.3
Elements of the Balanced Scorecard


• Both internal finance for management and external reporting
• The level of satisfaction and engangement of the recipeint of services, key stakeholders and the public in general.
Finance
Client
Learning & Growth
Internal Processes
• Focuses on measuremen and monitring of performance to improve. Emphasis on people, information and culture.
Focuses on the efficiency and effectiveness elements of program design and delivery.

For internal management, the balanced approach to performance measurement forces the organization to state explicitly what is important and what is not. No one set of metrics dominates and there is a combination of soft and hard measures. The advantage of a balanced approach is that it provides a fuller picture of performance. Used wisely, it balances finance, performance and the end-user of the program or service. This creates a more holistic view of organizational performance. The disadvantage is that such scorecards, unless well designed, can become incredibly complicated. They can become an end in themselves, requiring a commitment of time and energy disproportionate to the attention they receive and their utility within the organization. As well, the development of complex measurement schemes can disengage what the central office needs and wants to know and what information the actual operations need to manage. Such a tension is normal in any organization, especially ones that are geographically distributed and program-based. This can create a sense that the numbers are just there to fill in the forms, providing nothing more than phony metrics.

There is no such thing as a perfect performance measurement tool because of the complexity of organizations especially those in the public sector. The balanced scorecard is seen by many agencies as a useful tool because of its integrative nature. When implemented well, it can provide decision makers with the insights needed to assess their progress towards the achievement of its strategic goals and make adjustments. The balanced scorecard's limits, however, should also be understood, in order to avoid reducing the agency's complex activity to a set of

1. T. Jackson, "Dashboards vs Scorecards: Deciding Between Operations & Strategy" (blog post: 2016, February 25). See clearpointstrategy.com/dashboards-and-scorecards-deciding-between-operations-strategy
2. R. S. Kaplan & D. P. Norton, *The Balanced Scorecard: Translating Strategy into Action.* (Boston, USA: Harvard Business School Press 1996). See also P. R. Niven, *Balanced Scorecard: Step-by-Step for Government and Nonprofit Agencies* (Hoboken, USA: John Wiley & Sons, Inc. 2008).

performance indicators that may, or may not, prove relevant in the long run.

Experience in government in the past three decades points to the need to develop a mix of measures of performance. Certainly, they must reflect the basic forces that drive the government's agencies, such as financial discipline, client-focus, efficiency and effectiveness. As such, any performance measurement system must be balanced. It must also be relevant in terms of what is being measured and how the various measures relate to the agency's strategy. In that sense, the system must be coherent and understandable. While there is no one product that will guarantee the success of using a suite of measures, the underlying principles are useful.

Annual Reports and the Emergence of Citizen-Centric Reporting

We have already discussed the annual report as the consolidation of financial reporting. However, over the past two decades governments have tried to make great sense of the numbers for their citizens. They have tried to tie program results to money spent. However, in the movement generally known as citizen-centric reporting, they have tried different ways to present information both in terms of the greater use of graphics and the introduction of data that makes the information more personal. This is more than a pubic relations effort. Many citizens have complained that they do not understand what their taxes are spent on. They have also complained that traditional annual reporting, often mandated by legislation, is dull and hard to understand. While the financials have to part of such reporting, pulling out salient features and highlights makes them easier to understand. Further, this type of annual reporting sets the strategic and policy context for the financial information.

The objective of citizen-centric reporting is to improve transparency, trust and accountability. The structure varies, but follows certain basic formats:

- **The story:** What is the strategic direction of the reporting entity, what are its chief demographic characteristics, what does the entity do that is relevant to the lives of citizens? For instance, the City of Kingston, in its 2018 report entitled "2018: Your Taxes at Work," available at www.cityofkingston.ca/residents/property-taxes lists six strategic priorities:
    - Create a smart economy
    - Invest in infrastructure
    - Green the city
    - Plan a viable city
    - Advance a vibrant waterfront
    - Foster open government
- **Key performance areas:** Many jurisdictions involve citizens to determine what key measures to report. Similarly, governments or councils, both municipal and First Nations, will want to emphasize measures that highlight their priorities. A good example is the 2012–13 Annual Report of the Tsawwassen First Nation, which list targets for each of its program areas and provides a narrative entitled "How We Performed." For the reporting period 2015/16, Tsawwassen also produces an information pamphlet summarizing key performance indicators and its performance level, available at www.tsawwassenfirstnation.com . Another excellent example is the Region of Peel's 2018 Report, available at www.peelregion.ca/dashboard, which combines elements of an annual report, complete with financial statements and a dashboard to key indicators that lists ongoing services, providing volume of service or results of satisfaction surveys and links these to the regional council's priorities.
- **Quick view financial basics**: In graphic form, the costs of services and the sources of revenue to pay them has to be shown in an easy-to understand manner, best linked to the core strategic directions. The Kingston report breaks down expenditures into amount spent per resident for the principal services of the city. It then links to the city's formal financial statements.
- **Major challenges going forward**: This form of reporting incorporates a risk perspective that is respectful of the need for citizens to understand what challenges exist, even in the middle of what may well be a very good story on financial performance. This improves credibility and accountability. The Tsawwassen report provides a section on a risk management issue.

There are many examples of governments working hard to move away from abstract and detailed reporting to forms that are more useful to citizens. Much progress has been made in Canadian municipalities and in First Nations than at more senior levels. For example, the federal government's departmental performance reports maintain a traditional approach to report, even though they do offer some summary information at the beginning. However, the use of graphics and the effort to make it clearer to citizens

about what the department does and how it affects them is not there.

Summing Up

There are many ways to gauge how a government or agency is performing. This is a part of overall financial management where we are seeing considerable innovation. Part of the reason for this stems from the amount of criticism that traditional reporting efforts are too complicated, too bureaucratic in their language and too difficult to follow and relate to their impact. Efforts in this direction run the risk of merely being overly simplistic public relations efforts rather than a grounded effort to inform citizens on government performance. Well done, they enhance an understanding of how public funds are being spent, a greater trust in the delivery of services and confidence in government. Certainly, one test of the credibility of these reports are the frank and open reporting on failures to meet targets, along with explanations, as well as some form of forward-oriented assessments of the remaining challenges and risks ahead.

Performance information is also vital for the management of agencies for decision making, control and monitoring and meeting the internal reporting needs of government. However, no matter how good the performance information, all of these activities are governed by more than evidence of information. There is a mix of forces that drive such decision making, such as organizational culture, governance, leadership and political will. The reporting has to be good, but it does not address all the issues of effective financial management.

The ultimate test of whatever tools are used to measure performance is whether or not the information is useful and used. But this test is a multi-dimensional one, as there are both producers and users of that information. In the public sector, that means understanding that performance information can became political very quickly, that there are cultural divides between producers and users and that such information has to increasingly be provided on multiple channels and in multiple formats. Engaging the user in the design is very important.

Chapter 13
Oversight and Audit

The need for audits has been with us for a very long time. In fact, the ancient Egyptians used auditors to control transactions for the royal treasury. They also established detailed records of their work and the resulting transactions. Thus, the notion of using people and systems to safeguard public funds and provide a check against corruption runs deep in our culture.

Audit, Financial Management and Accountability

Effective internal and external audit systems exist to serve the need for public accountability. However, these systems do not provide accountability on their own. That rests with the individual or agency that has taken on the responsibilities and powers to do something and must account publicly. Audits, in their various forms, are control tools to be used in both assessing performance and holding those accountable responsible for compliance to both their own objectives and the means approved to achieve them. The core of the audit process is to take the policy and program that an agency has in place and determine if it is carrying it out in terms of compliance, financial probity as well as effectiveness, efficiency and sustainability. Auditors neither create policy nor manage programs. Their independent role prohibits this. The managers manage programs and the kind of oversight that an audit provides in government is vital to ensuring that management is held to account.

There is a tendency to see audits as part of a blame-game culture in government. That can happen, especially when egregious mismanagement or misuse of public money is found. For the most part, audits, whether they be from the internal audit service or the external auditor, are important ways to make corrections, identify trends and build trust in the quality of performance reports. That being said, there can be considerable tension between auditors and those they audit. Auditors are often the bearers of bad news for an agency or government. Internal auditors, those serving the agency itself, have this same problem. Their reports are often the source of scandals, headlines and enhanced public scrutiny for governments when the results of their audit go public, as all inevitably will in government, whether by law for a legislative auditor or through voluntary disclosure or accessed internal audit reports. As such, they must take great care to be independent in their work, to be completely professional and to be evidenced-based in their findings.

Auditing, as we shall see, is a process that provides a vital linkage that supports the accountability relationship discussed in **Chapter 2**. In fact, we will now add an audit dimension to the model of accountability outlined in **Figure 2.2, The Accountability Dynamic** in **Chapter 2** with **Figure 13.1, The Accountability Dynamic: Model of Accountability, Reporting and Assurance**. This model provides a third-party assurance that the essential accountability relationship is working and that the information, both financial and performance information, can be trusted and used with confidence. The goal of auditing is to provide decision-makers, legislators and the public with objective information to give them assurance that the representations of performance, be they formal financial statements or performance information corresponds to standards, actual results and is free of error or misrepresentation. Key characteristics of audits is that they be independent, objective and reliable.

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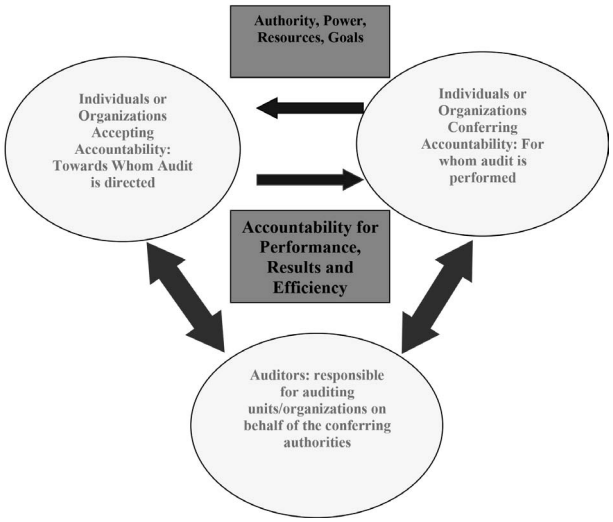
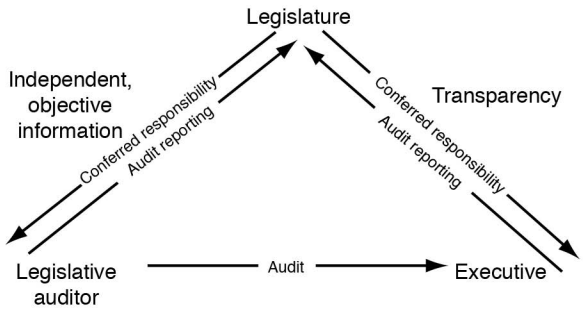
Figure 13.1
The Accountability Dynamic: Model of Accountability, Reporting and Assurance


Authority, Power, Resources, Goals
Individuals or Organizations Accepting Accountability: Towards Whom Audit is directed
Individuals or Organizations Conferring Accountability: For whom audit is performed
Accountability for Performance, Results and Efficiency
Auditors: responsible for auditing units/organizations on behalf of the conferring authorities

Who or what the governing body or user of audit findings is depends upon the accountability relationship. It can be a board of directors, internal management at superior levels, a minister, parliament, a city council, or First Nation chief and council. It can also be the CEO of an agency or deputy minister of a department benefiting from internal audit assurance.

In describing the public sector accountability process and where audit fits into it, Wayne Cameron, former auditor general of Victoria State, Australia offers this diagrammatic view of the process in **Figure 13.2**.

Figure 13.2
The Audit Triangle



Source: Wayne Cameron, "Public Accountability: Effectiveness, Equity, Ethics," *Australian Journal of Public Administration* 63, no. 4 (December 2004): 59–67.

This triangle shows the dynamic nature of accountability and audit. And, as Mr. Cameron points out, an audit does not replace the need for managers to account. Rather it is a key form of risk mitigation and assurance:

> For the minister and departmental officials, the key channel of accountability remains the chain of responsibility, upwards through the departmental hierarchy to the secretary and the minister and, via the minister, to parliament and the public. This central channel is supplemented by a number of other accountability mechanisms, including the accountability of public servants to respond to enquiries by parliamentary committees, to those agencies, which through their statutory roles, reinforce public accountability such as the Auditor-General, the Ombudsman, tribunals and the courts, as well as freedom of information.[1]

Auditing is part of the control framework for any agency and a significant part of oversight by governing bodies for external audit. How much audit there is depends on the size, complexity and amount of public money involved. The greater the complexity, and the greater the risk, the more there is a need for an internal audit function, in addition to a separate external function.

All federal and provincial governments have a form of external audit office, reporting either to the legislature and created by legislation and, hence, referred to as a legislative auditor. Similarly, most large municipalities in Canada have a form of auditor general function reporting to the council. While the focus of this chapter is on financial and program results audit, there will also create specialized oversight agencies with audit functions where the public policy requirements exist. For example, the Office of Official Languages for the federal government of Canada regularly audits departmental compliance with the Official Languages Act. The only example of a First Nation auditor general model is not Canadian, but certainly worth noting as it meets all the criteria of a legislative auditor, is the Navajo Nation Auditor General whose office provides external auditor services to the Navajo Nation Council in the United States.[2]

Similarly, most large governments have some form of internal audit. Internal audits' focus is on the internal workings of the agency. The client for an internal auditor

1. Wayne Cameron, "Public Accountability: Effectiveness, Equity, Ethics," *Australian Journal of Public Administration 63*, no. 4 (December 2004): 59–67.
2. For more information, see http://www.navajoauditor.org/

is the CEO, usually reporting through an audit committee that is supposed to provide independent oversight.

At the heart of the use of audit in either case is the need for public and independent assurances on two fronts:

- **Attestation** that management's information is fairly and completely represented, be it financial information (for the most part it is) or any other information that management offers, and that it is presented in conformance with practice, standards and rules.
- **Assessment** and reporting on management's performance is made in comparison to the approved purposes of the program, its stated objectives and goals, as well as the need for economy and efficiency.

Auditor General Cameron describes this as the difference between *conformance* and *performance.*

Categories of Audits

There are three ways to categorize audits:

- **Occurrence**: Does the audit take place before or after the activity of the organization takes place?
    - An audit that occurs before the activity is an *ex ante* or pre-audit. This is designed to determine the propriety and correctness of the transaction before it is completed in order to reduce risk to an absolute minimum. It will deal with such matters as the authority of the individual to authorize the transaction, the correctness of the calculations and the adherence to requirements.
    - An audit, regardless of purpose, that occurs after the individual transaction or the accounting period for the organization is an *ex post* or post audit. This can be performed by internal or external auditors. It can also focus on a much wider range of audit concerns such as meeting objectives, efficiency in doing so, effectiveness, etc.
- **Internal or external**: Is the audit conducted by the staff of the organization (or auditors under contract to the organization), or by an external auditor?
    - An internal auditor will perform a range of audit functions, but the client is the senior management of the organization.
    - An external auditor will usually report to the authorizing institution of the organization.
- **Scope of the audit:** In both internal and external audits, the scope can vary from strictly financial to broad outcome concerns.
    - **Financial**: this involves attestation of accounts, confirmation of actual expenditure to planned spending and compliance with accounting procedures, true representation of costs, full reconciliation of all accounts.
    - **Economy**: Comparisons of planned input costs to actual input costs is one form of economy audit. For example, in the purchase of equipment, was the estimated cost of a large and complex piece of equipment what was actually paid? If not, why not?
    - **Efficiency**: Was the goal of the organization met at the lowest cost possible?
    - **Effectiveness**: What were the actual results in comparison to the planned ones? Did the organization provide the right services?
    - **Sustainability**: This has two dimensions that will preoccupy many organizations:
        - Is the organization in a position to achieve its desired results over time?
        - What are the impacts in terms of the social, economic and environmental costs associated with attaining the goals of the organization?

Internal Audit Functions

The management of a public agency has to demonstrate that it can control its resources. For government, however, especially for those agencies of government that have many financial transactions, either in the area of entitlements (pensions, social assistance, etc.) or grants and contributions, the internal capacity to review, either *ex ante* or *ex post*, is an important one for internal control.

Some of the functions of an internal audit are to:

- Review and provide advice on the adequacy control systems of the organization by testing them and reporting on results.
- Assess project control capacity for large, high risk projects where risks are high.
- Ensure that adequate measures are in place to minimize theft, fraud or misrepresentation.
- Monitor and evaluate the risk management processes.
- Ensure that grant and entitlement decision-making processes reduce errors to a minimum to prevent overpayment and the need for recovery.

- Ensure that regulations covering how funds are spent, recorded, and controlled are adhered to.
- Attest to the accuracy and integrity of the information in the financial and reporting system.

One of the most important roles that an internal audit performs is to provide assurances to senior managers that the control systems they have put in place are working.

Risk and Materiality in Determining What to Audit

Audit resources are scarce. What an agency chooses to audit will be driven by two factors: materiality and risk. We have addressed both factors elsewhere, most notably in discussing control. From an audit perspective, materiality is the extent, either quantitatively or qualitatively, of an omission or misstatement in accounting information: error rates – or an impact of error – that would create a misrepresentation of the financial condition of the reporting entity, or represents a distortion of the anticipated performance results. Clearly, the degree of potential distortion or impact on the agency is important. While some tolerance of error is to be expected in any enterprise, some things just have to be right. In other instances, management can build in tolerable variances, above or below which further actions need to be taken. Figure 13.3 shows some of the risk categories that will attract audit resources.

Figure 13.3
Audit Risk

complexity, degree of error, high degree of program judgement
Audit Quality Risk: Faulty processes produce distorted results
Audit Risk
Control Risk: Potential for control failure or absence of adequate controls
Detection Risk: Mistatement or control error not detected

Some of the areas in which an audit may be required as a result of materiality are:

- Misstatement of financial statements, thereby requiring a restatement
- Financial transactions above certain predetermined levels
- Highly visible items, e.g., international travel
- Areas where the failure of compliance can lead to significant harm to the public, the agency, or its political oversight.

Audit risk is the risk that an auditor may unknowingly fail to provide an accurate opinion on financial statements. This involves such risks as poor sampling, which fails to provide an adequate picture of areas of error or misstatement. In determining risks that might lead to audit action, one that has been mentioned, but that is pertinent in this context, is control, i.e., the failure of the existing control framework to function as planned or to take into account a shifting risk environment.

Taken more broadly, the risks inherent in the financial, human resources, and operational activities of the organization as discussed in the section on control apply in determining the audit program.

Need for Independence

Internal audit generally has to have a significant degree of independence, and be seen to be able to exercise that independence in order to be effective. While it clearly serves the needs of the organization and, in particular, the chief executive officer, it must be able to function without interference with its audit activities. Therefore, the internal audit should be sufficiently independent of the activities that it audits to enable auditors to perform their duties in a manner that facilitates impartial and effective professional judgements and recommendations. The auditors should have no executive responsibilities. This means that they should not be operating or managing any activities that will themselves be subject to an audit in the future. Further, their involvement in the management structure of the organization should be sufficiently distant from both line and staff functions such that they can readily audit either.

For many years, especially as governments downsized, some organizations reduced the size and scope of internal audits. Moreover, they integrated it into other corporate functions, thereby creating a potential conflict of interest between those who audit on behalf of the organization and those who manage. In general, most audit standards

suggest that internal auditors report to the organizational head, to ensure direct access and independence. Many organizations dilute this relationship by burying the function below the level of direct reporting to the CEO. That often reflects the individual orientation of the departmental or organizational head. Where reporting relationships are not intended for internal audit, some additional efforts have to be made to assure independence.

Similarly, there is a tension between the role of the auditor, in examining and reporting, and the role of the audit advisor, providing advice on risk, materiality and program design that would prevent financial or program errors. The latter is forward orienting, centred on planning and engagement with line managers and staff within the organization. The latter is retrospective, and fits with a much more traditional view of the internal audit function. The reality is that public agencies need both kinds of audit services. The challenge is to ensure the integrity of the retrospective function while still being a team player in broader corporate activities.

The advantage of a good internal audit system is that it enhances control for the organization. It permits the organization to think about its risks, sets up a system for auditing risks suited to its needs, and gets at the errors before external oversight bodies do. These are valuable assets in the control of complex public organizations. The disadvantage of the internal audit function is simply that it is limited as the auditors, even with independence, still serve the departmental or organizational head. They are, in fact, part of the organization. Hence, it can be argued that their independence is somewhat constrained. While the organization will always be the ultimate arbiter of how to direct an internal audit and use its reports, it can put in place tools to ensure that there is adequate governance of the internal audit to ensure that its independence is safeguarded. This would be the role of the audit committee.

Audit Committees

The creation of audit committees in public-sector organizations has been driven by the failure of governments to effectively use internal audits to prevent misuse of funds. It has also been driven by private-sector scandals involving poor internal oversight tools leading to major accounting errors, misuse and fraud.

An audit committee is generally a committee of the executive group of the organization. Generally, it is chaired by a non-financial line manager, or what is known in the private sector as an independent board member.[3]

Some of the functions of the audit committee are to:

- Establish, for approval by the executive committee, the terms of reference for internal audit.
- Advise the executive committee on the effectiveness of the internal audit strategy.
- Review and recommend the resources allocated to internal audit.
- Assess the periodic work plans of the internal audit, any material changes to these plans, the head of internal audit's annual and interim audit report(s), and any implications arising from their findings.
- Ensure that the independence of the internal audit function is maintained.
- Assess and advise on the adequacy of management's response to internal audit advice and recommendations.
- Oversee the arrangements made for co-operation between internal audit, external audit, and other review bodies.
- Ensure that selection, monitoring, and training are in place to meet the requirements for the post of the head of internal audit.

In some governments, internal audit has become a centralized and shared service among departments. For instance, in 2003, the Alberta Government Deputy Ministers created a central function called the Office of the Chief of Internal Audit, with an audit charter. In this instance, the Audit Committee is made up of senior deputy ministers, including the deputy minister of the Cabinet Office, the most senior administrative position. The Audit Committee reports to the Deputy Minister Executive Council. It conducts or contracts for all internal audits as well as for cross-governmental internal audits.[4]

One role that the internal auditor plays is that of liaising with external auditors, as well as central agencies that usually provide policy guidance on internal audits. Of course, central agencies and external auditors value their own independence. However, having an auditor talk to an auditor is a good communications strategy for explaining how the organization manages its control frameworks. Hopefully, this can be a means of reducing effort and

3. An independent board member is one who has no employment or contractual relationship, nor a proprietary interest, in the organization on whose board she sits.
4. The Charter of the Office of the Chief Internal Auditor and the Audit Committee can be found at http://www.gov.ab.ca/home/index.cfm?page=856

duplication, especially when the plan for internal audits effectively addresses high risk issues.

External Audit: The Legislative Auditor

The role of the external auditor is similar in form to the internal auditor, but that person serves a different master. Rather than being a service to the agency and its executive to provide assurance on financial and effectiveness matters, the external auditor reports to the authorizing body, either a legislature or council or to the board of the agency. It is intended to provide an independent and public eye on the soundness of financial practices and whether the agency or government, for that matter, are achieving the best value for the money being spent.

Originally, many legislative auditors were created as the sole government audit function, essentially being the internal auditor. The functions today are quite different, as illustrated in **Figure 13.5.**

Figure 13.4
Role Statement of the Provincial Auditor of Saskatchewan

The Lieutenant Governor in Council appoints an auditor to audit our Office. The auditor must be an accountant who is a member in good standing of a recognized accounting profession that is regulated by an Act. The auditor can not be employed by a Government department, a Crown agency, a Crown-controlled corporation, or by the Office of the Provincial Auditor.
Annually, the auditor reports to the Legislative Assembly whether, in his opinion:
- our financial statements are reliable.
- we have adequate management systems and practices.
- we have complied with laws that govern our Office.
- our reported costs of auditing government organizations are reliable.
- our reported actual time employees spend on tasks are reliable.
- the assumptions underlying our request for resources (annual budget) are suitably supported and consistent with our goals, objectives, strategies, and action plans, and that the assumptions provide a reasonable basis for our request.

Source: Provincial Auditor of Saskatchewan: http://www.auditor.sk.ca/paweb/aboutouroffice.html

From the view of legislators, the value of legislative auditors has not simply been in their technical expertise on the financial side, but on their increasing focus on the efficiency and effectiveness of government spending, known as value for money.

In terms of the role of external auditors in assessing the state of the agency or government's financial statements, they have three principal tasks. The auditor must provide an opinion, contained in the financial statements themselves, as to whether the accounts of the government:

- Are true and fairly presented according to accounting standards.
- Ensure that money approved by the legislature was used for the purposes intended.
- Represent financial transactions covered in the accounts are in accordance with the relevant authority that governs them.

A financial audit follows established criteria, usually applying standards set by the Public Sector Accounting Board. Certified accountants and auditors collect data from a sampling of financial transactions. The language of the findings is specific and limited. The attest, as it is called generally, finds that no errors were found based on the sampling technique. It does not state that all financial transactions were correct or well spent, rather that the sample conformed to the accounting rules. Where the auditor finds either an error or a disagreement on the application of specific accounting principles, the opinion will contain a reservation.

When external auditors focus on value for money, their studies focus not strictly on financial reporting, but on broader questions, such as:

- **Economy:** Is the organization using the resources that it has in the best possible manner to achieve its objectives?
- **Efficiency**: Were the objectives of the organization reached at the lowest cost?
- **Effectiveness**: Were the results obtained consistent with stated goals?
- **Sustainabilit**y: Have the organization's actions and use of resources put it at risk of carrying on or being able to function effectively in the future? This is also called stewardship.

Independence

Independence – the state of being impartial and free from bias and conflicts of interest – is the cornerstone of auditing. Anything that impedes an honest and straightforward approach to the performance of an audit will reduce public confidence. The fact that this independence is backed by legislation instills public confidence in the process. For instance, were a legislative audit to reveal significant matters critical to government, those matters would, by law, have to be made known to legislators and the public.

To be independent in appearance, as well as in fact, legislative auditors have been granted the capacity to act without direction or interference from government. Any efforts to circumscribe that freedom are generally met with public opposition. In practice, and subject to statute and professional standards, this means that legislative auditors are able to determine when and how audits will be conducted and who will conduct them. They, for the most part, have the license to set the audit program for their jurisdictions, to choose the bodies to be audited, to determine the nature and scope of audits to be conducted, and to decide whether their own offices will carry out the work, or contract that work out to private-sector auditors. They take direction from the public accounts committee of the legislature when it asks that a specific audit be conducted.

The practices used in the appointment of an auditor general vary across governments. However, in all cases, the legislature is involved in some way in ensuring their independence. In most Canadian jurisdictions, legislative assemblies have assured this independence in a number of ways:

- The legislature usually has some involvement in the appointment of the auditor.
- Appointments are generally for fixed terms, with removal permitted only for cause or incapacity.
- Remuneration of the legislative auditor is usually attached to a reference group, to prevent governments from changing pay levels when one too many bad reports comes in.
- Legislation provides legislative auditors with immunity from legal action.
- Legislation allows legislative auditors to decide how best to undertake audits (for example, by using in-house staff, contracted staff, or contracted firms).

Legislated Mandate

For most jurisdictions there is an act of the legislature creating the auditor's position and outlining the duties. **Figures 13.4** and **13.5** are illustrative of the auditor's mandate and duties. Some important elements that are usually included in legislation are:

- The scope of audit mandate, including all departments, and potentially including related organizations such as Crown corporations and arm's-length agencies.
- The authority and duty to report back to the legislature.
- The authorities to investigate without encumbrance (a guarantee of independence).
- The identification of the legislative auditor as an officer of the legislature.

Figure 13.5
Duties of the Auditor General of the City of Toronto

As approved by City Council, the Auditor General is empowered:

a. to conduct, or cause to be conducted, audits on behalf of City Council in the areas of compliance, financial (excluding attest), program or value-for-money, information technology infrastructure, environment, and sustainability; and other audits as appropriate.
b. to undertake forensic investigations including suspected fraudulent activities.
c. to oversee the work of external auditor(s) performing financial statement/attest audits.
d. to examine problems and carry out special assignments identified by the Auditor General, or approved by 2/3 majority resolution of Council.
e. to provide assurance that the information technology infrastructure contains adequate controls and security by ensuring the existence of such controls in existing systems, assessing overall computer security including business continuity (emergency) planning.
f. to coordinate audit activities with internal auditors and any contracted work to ensure efficient and effective use of audit resources.
g. to manage the fraud hotline; refer issues to departmental management and the Internal Audit Division as appropriate.

Additional powers

a. The Auditor General shall have access to any records necessary to complete audit work.
b. Staff of those organizations within the Auditor General's scope have a duty to co-operate with the Auditor General and to not obstruct audit activities.

Mandate

The mandate for the Auditor General's Office was approved by Council and empowers the Auditor General to assist City Council in holding itself and its administrators accountable for the quality of stewardship over public funds and for the achievement of value for money in City operations. It establishes that the Auditor General shall be responsible for carrying out financial (excluding attest), compliance and performance audits of all programs, activities, functions of all City departments, agencies, boards…

Accountability and Oversight of Arm's-Length Agencies and Contracted Services

The growth of arm's-length delivery arrangements through contracting with both the private and not-for-profit sector is a trend that started in the 1990s and one that will continue in the future. It advances a well-founded concept of multiple delivery channels for public goods, and the notion of partnerships of various forms and meanings.[5] However, as Gabriel Meagher and Karen Healey of the University of Sydney point out: "Paradoxically, the ideal of partnership is being inscribed in public policy at a time when managerial reforms threaten to intensify the tensions between government and non-government agencies."[6]

Third-party arrangements do pose additional challenges to meeting the accountability requirements of public-sector financial management. However, their existence does not in any way diminish accountabilities and the need to report on both performance and conformance. Rather, it changes the ways in which this might be done and distributes the burden of design, assignment of responsibilities, and measuring, monitoring and reporting results differently. The current literature makes it clear that this is a work in progress. As Donald F. Kettl has pointed out, governments have to learn how to be more contract management savvy than they have been in the past.[7] Similarly, a series of public controversies about contracts, grants, and contributions, most notably the HRDC political firestorm of the early 2000s have led to what is commonly called a "contract chill" in which process measurement and control have taken precedence over the results.

Contracting for services is hardly new to government. However, over the past twenty years and closely associated with the new public management[8] phenomenon in various countries, it has increased. Third party delivery by private or non-profit entities has increased in a range of government services. Many governments view this flexibility in delivery as positive. They believe that they can realize savings in buying rather than building service delivery tools. Further, through the integration of "back room" services, i.e., those support functions that generally have no public profile, they can realize the benefits of both centralization and, to some degree, out-sourcing. Finally, these arrangements can allow governments to decentralize and localize service delivery to the public through contracting that matches local circumstances.

However, despite the many benefits, the accountability questions raised through contracting for services and using third parties are many. Some are:

- Do the same standards of accountability that apply to government also apply to non-governmental providers?
- Are reporting requirements the same when the objective of contracting is to focus on results, not process?
- Is the public agency doing the contracting less able to be accountable for financial probity and conformance to rules? If yes, how does it ensure this takes place?
- Does the public agency managing the contract become a form of auditor as well as a buyer of services?
- Do private or public-sector financial standards apply?
- What is the cost and burden of reporting?
- As Robert Mulgan[9] points out, there are two factors that have an impact on accountability practices once a third-party arrangement is in play:
- Differing accountability practices between the contracting organization and the contractor, and the limits of adaptability, and
- Alteration of the management methodology from one of internal, hierarchical organizational relationship to a new contractual relationship that involves both a buyer/seller relationship and a continuing, partnership-type arrangement.

There are also a number of private-sector concerns with contracting arrangements:

- Commercial confidentially usually has to be negotiated into the contract to protect the firm from

5. The term "partnerships" does indeed cover the waterfront of joint policy collaboration with the voluntary sector to very tightly negotiated partnership agreements with private firms to construct a bridge. It remains a term that is problematic as it implies something closer to a living arrangement than an exchange of goods and services.
6. Karen Healy and Gabrielle Meagher, "Caring, Controlling, Contracting and Counting: Governments and Non-profits in Community Services," *Australian Journal of Public Administration 62* (3), 2003.
7. Donald F. Kettl, *The Global Public Management Revolution*, 2nd edition (Washington, DC: Brookings Institution Press, 2005).
8. The literature on new public management is exhaustive. For a good overview of the most recent developments, see Salamon, *Tools of Government*. Similarly, Peter Aucoin, "The New Public Management: Canada in Comparative Perspective" (Montreal: Institute for Research on Public Policy, 1995) is a good early introduction. For a more retrospective look around the world, see Andrew Graham and Alasdair Roberts, "The Agency Concept in North America: Failure, Adaptation, and Unexpected Benefits," in Christopher Pollitt and Colin Talbot, editors, *Unbundled Government* (London: Routledge, 2003).
9. Robert Mulgan, "Accountability Issues in the New Model of Governance," Technical Report Discussion Paper 91, Australian National University, 2002.

competitors: this often leads to some information being masked from public view.
- Private financing of government activities through arrangements for lease-back, long-term risk sharing, and/or build-and-lease arrangements are also different forms of activity that are not well understood in the public realm.
- The extent to which the private service provider or project manager must adapt and use public-sector values that involve transparency, equity and access, which would not occur in the private sector, is a concern.
- The basis of accounting and differences that arise may be difficult.
- Costs of reporting, monitoring and auditing need to be limited to the bare essentials.
- Governance that can produce resolutions to problems when they arise, that reduces the risk of project "creep" when the contracting government tries to add services or change terms of reference in mid stream may cause problems.

Establishing effective contract management to enable good financial administration demands that certain features of the relationship be well structured. Some of these are:

- A clear understanding of the desired outcomes or deliverables
- Clear definitions of accountabilities of all parties involved
- Good costing, not only of the services or goods delivered, but also the oversight costs
- Appropriate contract design and contract process administration, including the addition of probity audits in real time for high risk contracting processes
- Clear guidelines on reporting requirements by both parties
- An agreed cash flow arrangement
- Effective contract governance to enable problem solving, and
- Appropriate post-contract evaluation.
- Audit concerns for contracted arrangements should include questions that ask the following:
- Has a due diligence enquiry (including consideration of issues such as financial stability, training programs, management style, and insurance coverage) of any potential service providers been performed?
- Are the risks, which will be created through entering into a service provider arrangement, understood, and are there processes in place for managing these?
- Have service level agreements (or similar) been documented and agreed to by both parties?
- Do the service level agreements adequately identify the respective roles and responsibilities of the agency and the service provider?
- Do the service level agreements include monitoring, reporting (including against key performance indicators), escalation, and conflict resolution clauses to ensure that issues can be addressed appropriately?
- Has the agency confirmed that the selected provider has controls to ensure the privacy and security of the agency's data?
- What controls and security practices does the provider enforce to provide assurances that critical information is handled appropriately?
- Is there ongoing communication between the agency and the service provider about the work performed?
- Are there documented processes for raising issues of unsatisfactory performance with the service provider?
- Are there processes to ensure that any fees charged by the service provider are appropriate based on the services provided, contracted costs, and service-level agreement requirements?
- Does the department obtain sufficient and appropriate assurance from the service provider for the chief financial officer's annual statement to the accountable officer?

Third-party contracting in no way dilutes the accountabilities of public officials for the public good. It complicates that accountability, however. The costs of these new forms of accountability have to be factored into the overall assessment of the use of a third party in service delivery. However, the same has to be said for the cost of effective accountability with the traditional structures of the public sector. Neither is free.

Appendix 1
The Budget Games People Play*

The point has been made several times in this text that budgeting can be a process of competition for scarce resources. Therefore, the potential for winners and losers is always there. No manager wants to lose the budget game. Often, winning is just holding your own and not incurring losses in budget levels. Sometimes, it can mean additions to existing programs or the addition of some program enhancement for which the manager has been fighting for some time. Alternatively, it can mean budget reductions, driven by overall government reductions, program changes or shifting priorities.

The budget game has real consequences. Skilled players will win for their cause. That means that they have to develop plays and execute them well. Often it means having just the right timing, with the right set of proposals well thought out, to fill a gap or need. There can be trade-offs with other players. All budget cycles involve a series of accommodations and compromises leading to a set of fairly narrow decisions by the top leadership, be it a prime minister or a city council or a board of directors.

Parties to the game should be aware of the plays that have developed in many bureaucracies. What follows is a *tour d'horizon* of such ploys. They break down into four categories:

1. Getting new programs funded
2. Defending existing programs
3. Resisting cuts
4. The senior manager's defence.

In a number of these, an appropriate response by senior managers is suggested as well.

Getting New Programs Funded

1. Creeping Incrementalism

How it works: Sell a modest program initially; ignore its real magnitude until after it has gotten under way and build client and constituency support for the program. In many cases, float ideas on a pilot project, demonstration project or "seed funding."

Example: One provincial official suggested to her federal counterpart that it would be a good idea to make immigrants with landed immigrant status eligible for unemployment insurance. While all agreed that this would be a good thing and decided to go ahead with it, no one did the ultimate costing, which grew dramatically over the years and transferred budget costs from the provinces to the federal level. Once the higher costs were fully understood, it was politically impossible for the federal government to back down.

Resistance: Reject the proposal up front as poorly conceived and use the **thin edge of the wedge** counter-ploy, as in: "This could just be TEOTW (The End of the World) and who knows where it will end." Another good phrase to use is, "This could be a slippery slope."

Build in sun-setting provisions with evaluative procedures before approving any further funding: most good bureaucrats will have a counter-strategy for that, but they will have had to work for it.

2. Chinese Box

How it works: Bury certain politically undesirable budgetary expenditures inside a larger, more palatable program to slip it under the nose of senior management.

Example: This has been done so many times, examples simply seem unnecessary: burying administrative embellishments in program improvements, e.g., a new financial system to support a new federal-provincial childcare agreement.

* The structure of this section, and many of the titles, were adapted from Robert N. Anthony and David W. Young, *Management Control in Nonprofit Organizations* (Homewood, IL: Richard Irwin, 1984). Some Canadian refinements have been added and the examples updated.

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Resistance: Demand detailed breakdown programs so that such items become visible. Demand cost breakdowns and more detailed information.

3. Split Infinitive: Divide and Conquer

How it works: Seek approval or sponsorship of a budget proposal from more than one source to a point at which there is commitment tied down or it would be difficult to withdraw approval. How to do that is a book in itself. However, any two-parent family with children will be able to see it in action most bedtimes.

Example: A common trick in large, complex organizations that have line and staff structures, is, for a line manager, to get some staff support and then go to her line boss with that approval, suggesting a virtual *fait accompli*. Once line commitment is secured, the manager then returns to the staff side and firms up support.

Resistance: This will depend on the organization. In some instances, as long as the manager keeps the lines of communication open, in particular with her boss, seeking multiple supporters for a budget proposal is just what is needed to get it in the budget. However, putting the ultimate budget manager in a squeeze like this deserves to be punished. Good planning and strategic thinking around budget proposals and a no-surprises policy is what works in the end.

4. Get the Tail to Wag the Dog

How It Works: Get budget approval for a specific item that is part of a larger program, which has not yet been approved. This then creates a stronger argument to approve the whole program.

Example: Seek approvals for systems upgrades in computer systems to improve client services to a new standard. The standard is not part of any new departmental policy, just a planning concept that the manager strongly supports. However, it is not approved. Should the systems upgrades be approved, the larger direction is, *de facto*, approved.

Resistance: This is difficult in many cases, as the overall objective or standard is often hard to argue with. As well, forcing the sponsoring manager to go back to basics and obtain the policy approval will meet with resistance. However, that is the only real solution.

5. Using Magic as an Accounting Device: the Shell Game

How It Works: Propose a budget item or change with an assumption that the real cost to the organization will only be a portion of the end cost and that the other funds will come from (get ready for a stream of bureaucratic clichés here): partnership funding, equal sharing, matching funds, etc.

Example: This is an oft-used Canadian government tradition in which the federal government offers what are called 50 cent dollars, i.e., for a program, it will pay half the costs if the province pays the other half. Similarly, for the volunteer sector, this becomes a trap in which the donor agency, often government, will match funds raised for a program in which it has a highly visible role. This, then, puts the volunteer agency in fund-raising mode.

Resistance: Senior management must be aware that close cost analysis is crucial here. Similarly, ensuring the sources of funding are there and verifying them is important.

6. The Gift Horse – It's Free!

How It Works: Obtain budget approval based on funding coming from another source.

Example: Under intense community pressure, a federal government MP finds capital funds for an MRI machine for the local hospital. The equipment is purchased and announcements are made. The hospital now has to operate and maintain the machine, costs that no one has factored in, but which will, over the usable life of the machine, be much greater than the cost of the machine.

Resistance: Look the gift horse in the mouth and check out long-term costs. Include these in the package costs that are presented to the enthusiastic donor or sponsor so that the whole cost of the program is funded.

7. The Word Came Down

How It Works: Imply to your boss that you had direction, or at least implied direction, from your boss's superior or higher level sponsors. This is similar to the Split Infinitive technique.

Example: Inform your boss that the budget item idea is not really yours, but one that some superior to your boss wants to push. This can be at the political level (minister's office), a board member, another senior official or someone in a central agency. Imply that your boss's unit would be favourably seen if it pushes this.

Resistance: The boss should try to get some form of formal support to back up this claim. Of course, the boss can simply pick up the phone and find out if the claims are true. The boss who doesn't see this one coming should be sent back to boss boot camp.

8. The End Run

How It Works: This is the reverse of No. 7. In this case, the sponsoring manager goes around his immediate superior and starts to lobby for a budget item or change in the hope of winning allies to pressure the boss.

Example: Use a briefing with ministerial staff to raise a possible budget increase in allowance for certain departmental clients. Say that it is to test the waters, sound out the minister's views and get a go-ahead to look into it. Take the conversation back to your boss as a direction.

Resistance: This is a major corruption of the decision-making process. It often puts the players in very difficult positions, unsure of whom to believe, and distrustful when the idea seems to be resisted afterwards. Anyone attempting an end-run of a decision-making process needs to be brought to task.

9. I'm OK, You're at Fault

How it Works: Find an error in budget instructions, their timing, or lack of direction on the boss's part. Use this error to lobby for more money for your budget on the grounds that the instructions made it impossible to properly present the case. Imply that things have gone on so long that the idea has to be approved.

Example: A really effective ploy here is to indicate that the budget instructions and limitations in them failed to take into account the direction found in the minutes of the board executive committee to factor in a certain issue in plans, even if the minutes were quite vague about the budgetary implications.

Resistance: This can be messy and can be a major gamble, especially if the boss is a reasonable person. It may pay to be unreasonable and stick to the holy grail of budgetary restraint. Alternatively, the boss can play the **Turn the Tables** ploy and instruct the manager to factor the budgetary items into her budget but retain the overall budget levels found in the instructions. Then the manager is stuck with delivering something with no new funding to do it with.

10. Only the Best

How It Works: This ploy is often used when there are alternatives and the manager wants the higher quality or higher cost solution. One sees this in organizations with a large rank and file with strong public support. Here, the manager appeals to corporate pride: we are the leaders and so we need this enterprise management system, which is "world class," "best of breed," or "leading edge technology."

Example: A small organization wants to buy into a leading computer system, even though it really does not need the level of complexity and functionality that it offers. However, it is "the best and we should use the best."

Resistance: A couple of tactics work here: the **Scrooge Ploy** and the **Analysis Torture Ploy**. The former puts the boss or decision maker into the nay-sayer role. The latter forces the emotional thrust of this argument through the sieve of committee review, a sure way to kill emotional appeals if there ever were any.

11. Show Me Yours

How It Works: This is really a question of what the neighbours have and you wanting to have it, too. The manager uses comparative techniques to embarrass the organization into supporting new budget items.

Example: Without arguing the merits of each item, police services are well known for checking out each other's equipment and using examples from other regions to get more budget funds to improve theirs.

Resistance: Resisting the contagion factor around some equipment purchases is tough. In some cases, the upgrades are necessary to avoid liability issues, and in others they are genuinely needed. However, using these comparisons on a regular basis without really knowing the benefits of these new items, and without standard setting, is dangerous.

12. Ahead of the Curve

How It Works: The manager argues that the budget item will put the organization at the forefront of one of… client service, technology, science, leadership, and the beat goes on. The operative phrase is "at the forefront." This is an appeal to organizational pride.

Example: A manager wants to equip all park staff with GPS equipment so they know where they are and can gather more accurate data on species counts, trail maintenance and repairs. Then, all this data will be assembled and analyzed.

Resistance: It pays to be confident in what you do as this will often work with the insecure senior manager who wants to look good. A more secure manager would demand a clear notion of the real benefits of these purchases. Further, they may use the counter ploy – **What Are You Going to Do With It?** – a tactic questioning what use this refined data would be and who would pay for maintenance.

13. The Pre-Emptive Strike

How It Works: The budget sponsor implies that if this is not done, someone else will do it and look good or hinder the organization from getting involved.

Example: The manager agues that if the department does not start its own program for employee assistance, a central agency will come in, write the rules, build in all kinds of oversight and possibly even make the department pay for it. However, by doing this, the department will be able to design the program itself.

Resistance: There will be a long list of requests for budgetary items like this, as they appeal to the organization's desire to protect its interests. Normal evasive techniques can work here, especially ones that delay or seek to clarify the other organization's intentions. Sending the manager out to find out the other organization's plan is one such technique.

14. Rebranding the Sows' Ear

How it Works: The manager uses appealing labels to sell a program. This may not be entirely misleading, but they do distort information.

Example: Most budget controllers will resist any attempt to add administrative support to a program. They will also resist adding capital to a program change. However, when the manager puts forward a program with part of the budget being for service delivery, and the other part for administration and capital, the intention is to distort exactly what it being bought and sell it under a better name.

Resistance: Senior managers have to have high **BS Factor Analysis Skills.** (Of course, in this instance, BS stands for blatantly superfluous.)

15. Send in the Experts

How It Works: Managers use experts to justify their budget increases.

Example: The use of experts from universities, consulting firms, or professional organizations in defending program changes is so pervasive that examples hardly seem necessary.

Resistance: The best technique senior managers employ is to use the **Dueling Experts** approach; i.e., bringing in counter views, which usually abound. Alternatively, discredit the expert, implying bias and poor research, or question credentials and suggest that the expert's work is inconclusive.

Holding the Fort: Protecting and Growing the Current Budget

1. Placards and Protests

How It Works: Most programs have clients, recipients or interest groups. Mobilizing them to do the work of fighting off budget cuts is a tried and true tradition in an organization. Whether this is done through manipulation by the manager or simply as an outcome of the review process, the result tends to be the same: heightened political tension, media interest, or possible retrenchment.

Example: During a recent cycle of budgeting in a large Canadian city, faced with cuts, the city decided to close a number of neighbourhood libraries. This led to protests in those localities that eventually saw the restoration of part of the proposed cuts. Community mobilization can work.

Resistance: This is often a test of political, rather than bureaucratic, will. However, such reactions are predictable and a legitimate part of democratic decision making. The key is ensuring that the political level understands and accepts the risk of public reaction. Whether it holds firm or caves to public pressure in the end is a challenge, as that level holds the decision-making authority. Another tactic is for the senior manager to thoroughly understand the interest groups involved in any budget move, and not to let these interests work solely with one manager. Rather, the senior manager would want them to have a higher-level contact, even the senior manager.

2. Spam Your Budget Increase Request

How It Works: Any increase you request will be supported by massive amounts of data, extensive presentations, and too much information for the senior manager to absorb. The *force majeur* of the quantity is supposed to drive out the real content. (This actually does work sometimes.)

Example: In order to get more funds for maintenance of information technology, include all repair and upgrade requests, all data on repair work, detailed schematics of the system as it is now (just to scare people), or a large, unprioritized list of change requests, even if they are upgrades. Bunch all of this together into a lump sum and present it as though it is barely enough that "will just keep you afloat."

Resistance: This is a good place to use the **Give Me Your Top Five** tactic. Given that the senior manager cannot sort through all the data, let alone make sense of it, she should just say, give me the top five priorities and we will see how much that costs. If this merits more attention, then ask for year-to-year comparisons and ask what has changed. Suggest that this kind of data might be worth a review by an outside expert – your outside expert. That will certainly cause sober second thought.

3. Time Ambush

How It Works: Rush submissions in at the last minute, thereby avoiding intensive scrutiny, claiming that the budget process itself was so much work that you had to come in past the deadline but, miraculously, before the final submission had been signed off by the senior manager.

Example: The senior manager set herself up here. She asked for complete information in all change requests. The manager needed to build up his maintenance budget for vehicle repair and wanted ten more vehicles. He knew this would not be popular, so he held back and rushed it in at the last minute. He claimed the information requirements forced him to do comparisons with other departments and that the senior manager's office was late in making the contacts for it.

Resistance: This is a setup, pure and simple. Often the request might be quite legitimate. Therefore, some sort of compromise might resolve the problem. But it is important to remember that budget cycles come around again. Therefore, the senior manager should put in place **The Pain I Can Inflict Is Greater than the Pain that You Can Inflict** tactic so that the manager feels the wrath caused by the time ambush sufficiently that he will not repeat it. For instance, while agreeing to the change, the senior manager could hold the funds in a special fund that she controls.

4. The Sacred Base

How It Works: The manager argues that last year's base cannot be changed without dire consequences. She uses the argument that the budget exercise is only about how much the increment or increase should be.

Example: While the senior manager wants to find as much flexibility in the budget as possible, one effective form of resistance is to treat the base as unchangeable. This is generally supported by volume data that shows no change in demand for the service. Further, cost increases should flood in to show the need for more.

Resistance: In fact, it is often the case that the base is not under question. It will depend on the degree of need in the budget process.

5. Aim High, Settle for Less

How It Works: The manager pads the budget requests to a level higher than really needed or than what he expects to receive. The reductions by senior management take him to where he expected to be.

Example: The manager inflates prospective fuel increases and volume demand projections to justify higher budgets in those areas. The senior manager reduces these projections but leaves the rest alone. Mission accomplished.

Resistance: Senior managers should never accept large unsupported cost inflation projections; they should build them into their guidelines and permit no deviation.

Resisting Cuts

1. Paralysis by Analysis

A key tool, but a dangerous one in the hands of skillful managers, is to call for a study when budget cuts are being proposed. Certainly, the use of external sources to study an issue has the immediate effect of subjecting the budget defender to scrutiny. However, a flawed study – and it will be a flawed study in someone's eyes – can often lead to problematic results. Careful control is needed. Such a study will have to be carefully designed, or it will be dismissed.

2. A Pyrrhic Victory

In the face of budget cuts, especially across-the-board ones, managers can propose changes that will either cost more to implement, e.g., getting rid of staff with high pay-out costs, or be politically problematic. The classic example is the perennial story, never actually documented, of the RCMP. When faced with budget cuts, offering up the Musical Ride, a wildly popular but hardly mission-central aspect

of their activities was the ploy. Of course, this would be politically unpopular, so the RCMP ends up with what it wants – no cuts. There is, for the record, no documented evidence that this ever happened, but it is a good illustration of how this ploy can work.

3. Unleash the Clients

Once again, this has already been factored in above, but it involves bringing in affected clients to oppose the changes.

Counter Attack: Senior Management's Responses

Some of the counter-measures that senior managers can use have already been mentioned in the ***Resistance*** *sections*. Already cited have been the following tactics:

- Thin Edge of the Wedge
- Turn the Tables
- Scrooge Ploy
- Analysis Water Torture Ploy
- What Are You Going to Do with It?
- BS Factor Analysis Skills
- Dueling Experts
- Give Me Your Top Five
- The Pain I Can Inflict Is Greater than the Pain You Can Inflict.

What follows are some other tactics that senior managers can use to ward off, or manage, budget tactics and games.

1. Hold Back

The senior manager ensures that various budgets do not get too independent of his control. Various means to do this are to not distribute all funds at the beginning of the year, thereby both holding more control, but also seeing if the funds are really needed. Another is to hold capital funds in a controlled reserve and distribute on request.

2. Count the Pennies

Effective delegation notwithstanding, an important way to be in a position to judge budget needs and the potential for cuts is effective cash management information and control of the current budget. Letting go of an awareness of how money is spent is bad management. Letting go of spending authorities based on a good plan is effective management. But it is still important to keep a window on what is happening.

3. The Madman Theory: Just Cut Across the Board

When resistance is at the maximum and there is a stalemate in the decision-making process, across-the-board cuts may be the only answer. Since the potential exists for paralysis by analysis and a lot of time wasted in a variety of defensive moves, the counter-argument that such cuts distort policy intent will just have to be swallowed in comparison to the costs of being reasonable.

4. The Devil Made Me Do It

Often, it pays to have an evil twin or another boss to blame. This is, in fact, often the case. No senior manager really has all that much unfettered discretion. However, if this argument is used, it may reduce the number of defensive ploys for managers. Of course, it may not do much for the esteem of the senior manager.

5. Meet You Half Way

The senior manager offers to cut a deal and fund part of the program. The pressure has to be on in this instance in order to end the process. In that way, the senior manager sounds half decent.

6. Let's See the Boss

This is a variant on No. 4: offer to go with the manager to discuss this item with the senior manager's boss or, even worse, with the executive committee. While some managers may leap at this chance for exposure, others will rightly see this as a very risky proposition. The manager may find herself out on a limb and hear the chainsaw – possibly in her own boss's hands – taking over her career planning.

Appendix 2
The In-Year Budget Management Games People Play

Hidden deep in the heart of every financial manager is a poker player. Once the game of getting the best budget deal possible is in play, the time comes to manage the money, manage it well, manage to your best advantage, and manage to guard it carefully. This calls for both defensive and offensive strategies. Sometimes using these strategies has worthwhile results, other times not. Managers will take risks and make predictions about their spending behaviour that, at times, are right on and at other times are not. Knowing how managers might behave is an important element of managing cash management outcomes.

The following describes a number of ploys that often occur in bureaucracies when managers are trying to defend their turf from intrusion, to guard their financial flexibility within their budget year, and still make sure that they will carry on next year with the same resources. Of course, woven into this is another series of ploys used to defend off-target behaviour and financial outcomes, i.e., when they go over-budget and a deficit looms on the horizon.

Every manager has an evil twin. This twin shows up at odd times. When money is involved and the possibility exists that the manager may lose some in the current fiscal year and that this might just cast doubts on next year's budget, this is the time when the evil twin comes out.

A reader might ask, is this any different from the games that have already outlined around budget formulation? In general, the tactics and strategies do indeed parallel each other. However, in-year budget management is a separate, but linked, task so can take on slightly different elements. Hence, this section is offered to outline these. In addition, as before, some potential managerial responses are suggested.

Disclaimer

By outlining such ploys, some of which involve questionable ethics, the author is not advocating their use. However, an alert manager will recognize that they are used regularly and will be ready to respond to them. In the end, however, good cash management is a matter of balancing the need to get the job done, the need to control both programs and costs, along with the need to meet the corporate goals of the organization as well.

One factor that all these ploys have to take into account is that very few public sector organizations will rely solely on the responsible financial manager for cash forecasts and spending projections. While practice varies considerably, and there is clearly no one way to do effective cash forecasting, the financial advisors at both the unit and corporate levels will be expected to either bring together all the line managers' projections into a single document or also offer their own projections. Often, organizations with relatively weak line financial management capacity will rely solely on the financial advisor to bring together the projections. Regardless of what the routine is, there will be some form of interaction that takes place which may challenge the line manager's projections or call them into question. After all, sound management of a hard-earned budget is a performance issue for managers.

Pre-Emptive Moves

These are ploys that seasoned managers will use to either over-play or underplay their cash situation on a regular basis. While they will comply fully with projection requirements and prepare all the forecasts that the system calls for, they will build into that work some way of portraying the information that essentially masks their true spending performance and leave them with ample margin to manoeuver throughout the year.

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1. Commit All the Funds Up Front

Rather than projecting a budget based on actual expectations or historical trends, simply take a stand that all your funds will be spent for the program and no surpluses will be available over the year. This will involve making a simple declaration, offering some evidence, and also making specific commitments of funds for special projects.

2. Reduce the Money's Visibility

This is not about stealing money. It is about making it less visible and less open to scrutiny by corporate line managers or financial advisors. It is a bit risky. For instance, monies could be transferred to a reserve fund or a specialized fund that is generally regarded as restricted. Though a side deal, it could be transferred back or spent for program purposes without actually accounting for it in the cash forecast for the program. Rather, it is, to all intents and purposes, not in view when the time comes to make decisions.

3. "We're Starving Here": Claim Under-Budgeting

Start your forecasting report with a claim that you do not have the funds you need to meet program needs, that you were under-budgeted, and now must scrape along as best you can. This gives the impression that you will need everything you have.

When Budgets Go Over

Naturally, no manager wants to go over-budget and be blamed for it. So, the ploys in this area often involve a lot of finger-pointing – away from the defensive manager. These ploys also involve a certain amount of plea bargaining to get help. It might be argued that the best course of action is simply to admit to, and project, a budgetary pressure early and deal with it. It sounds so simple you wonder why it does not happen all that often. However, there are many pressures inhibiting managers from admitting that they have problems: reputation, power, and protection of turf being only three of many. The nature of the alarm that an over-budget forecast sets off will vary from organization to organization. Often the urgency is magnified by the fact that such trends are not caught early enough through the poor use of forecasts at the corporate level. This exacerbates the situation and adds to the panic.

1. Blame Someone Else

Variance from planned expenditure patterns can be explained in many ways. Finding another party, preferably someone not in the room, or involved in the process, is a means to transfer responsibility. If the transfer of blame is believed, it may make the organization more amenable to helping you out. For example, stating that the action of central agencies has increased your costs in a way you could not possibly have forecast is a good ploy. Everyone hates central agencies. Be careful that you are not alone in making such a claim. Outside agencies that are slow to pay, or have caused increased costs, are a good ploy to use as well. Be careful with the use of this ploy because it will only be put up with so many times.

2. Live Above It

"I just can't stop serving my clients." – a noble phrase that puts you above the fray. Generally, when caught with external service cost overruns, you can use this kind of thing. Of course, you have to be able to clearly point to the unforeseen nature of this event.

3. The End Run: The Minister Made Me Do It

Claim that your costs were caused by political pressure that you did not resist. For example, you could say that to maintain a good relationship with a ministerial assistant, you gave in to pressure to fund a pet project in the minister's riding. Be ready for denials out of the ministerial assistant, of course. However, you can also do this by claiming the high road of having avoided political embarrassment through some assiduous expenditure that put pressure on your budget but saved the day politically.

4. Attack the Bean Counters

A good opener to this one is "Where did these numbers come from? They don't look like the ones that we use. What did you people in finance do to distort the situation like this?" Another ploy is to claim false comparisons in analytical reports. This works really well if there are inter-regional or inter-unit comparisons. Your defence is that your circumstances are not the same as the other region's, and that it is obvious that these numbers are not clean.

A good defence is for finance to get all reports signed off several times before submitting them. The battle to produce data that is not open to attack is a real one in organizations, and often is subject to phony attacks like the ones above.

5. The Sky Is Falling

Claim that the organization just doesn't understand the kinds of pressures it has created for your program. The

internal program pressures have been intense as well. All of this has worn out your staff and distracted you and your managers from numbers to manage all this pressure and panic. If there is not some relief it will only get worse and more visible.

Money About to be Left on the Table

One of the fundamental reasons for sound cash forecasting and management is so that funds budgeted will be used for the purposes intended. Unforeseen circumstances will affect the desired outcome either positively or negatively depending on the circumstances. Sound financial management practice seeks to identify whatever flexibility might emerge in the budget of the organization and use it to deal with these unforeseen events or demands. As well, there is always a positive use for additional funds, should they become available. It is a mortal sin to let money lapse that could otherwise be used within the organization. Some might argue that funds should be spent solely for the purposes intended. Indeed, such is the case. However, as we have already seen in discussing budgets, line items, and program parameters, there can be a great deal of latitude built into budget plans and authorities, usually intended to enable the organization to respond to fluctuations within the program. Operating legally and ethically within that room to manoeuver still permits the temporary reallocation of funds within a fiscal year to meet short-term demands.

For the manager who may "lose" such funds, this could be very threatening because the funds may be reallocated permanently to another budget. She may also have her own list of small projects and needs that she wants to use the funds for. Being a corporate player and donating to the greater good is just fine in theory, but not necessarily in practice, especially when you are the manager affected. One challenge for senior managers is to ensure that rewards systems are put in place to recompense those ready to give up funds for reallocation. Unfortunately, seasoned managers have been through too many situations when this has not happened, so defensive positions are built up.

1. Make a Side Deal

Lend money to another program that can use it this year with an understanding that they will pay you back next year. Of course, this requires having the authority to transfer the funds or to make expenditures on behalf of another program. This is easier than one would think, especially if the amounts are not highly visible. For example, you could buy 10 computers for a fellow director and then get her to buy 20 Blackberries for you the next year. All within your authority. All program related. This can result in money being protected from the vultures at corporate who want to help out the chump manager who is in real program trouble.

2. Attack the Bean Counters

Just keep at it. Suggest that they have not properly worked out your hold-back authorities and that you should retain the funds because of their poor calculations. Claim that the reallocations proposals are little more than a poorly concealed resource grab that will distort your program and rain down embarrassment on the minister. In the case of a decision, argue that the funds are just a loan, which you are making for the corporate good, and that you will need the funds back next year.

3. Extract Some Future Wiggle Room

Question what will be done with the reallocated money. Extract assurances that this is not a permanent loss of funds. Instead of fighting it, offer to make a loan to corporate (this requires you holding to the position that this is your money even though it truly is all corporate in the end) this year and, in exchange, you will get special authorities or consideration next year.

4. Pull in the Stakeholders

Make sure that your key stakeholders know that you might be losing money this year (and don't overly assure them about next year) for their program. This, of course, takes the gall of ignoring that you are probably doing all the program expenditures you can already and that the funds really are available. This is a very tricky ploy; one that might backfire. For instance, the stakeholders might turn on you and demand to know, quite legitimately, why the funds were not being spent. In another instance, your boss or the minister might get a highly politicized blast from the stakeholders and angrily turn to you for an explanation. This one takes brass.

Glossary

Accelerated depreciation

Technique that allocates a higher portion of a long-term asset's cost as an expense in the earlier years of its useful lifetime and a smaller portion in the later years.

Account

A category of financial event that the organization deems sufficiently important to be listed as a separate category, which can be captured in reports.

Accountability

The obligation to render an account of, and accept responsibility for, one's actions, both … the results obtained and the means used. – Report of the Auditor General of Canada, Chapter 7, March 2004. Accountability involves reporting results compared to agreed-upon expectations. Accountable people and organizations explain any differences between their planned and actual results: how much was spent, what was delivered, and what was achieved. – Annual Report of the Auditor General of Alberta, 2001–02.

Accountability framework

A process and potentially a document in which authorities are assigned to individual managers, along with specific objectives for the program, and measures to be reported upon for assessment purposes.

Accounting

A system for keeping track of the financial status of an organization, and the financial results of its activities.

Accounting controls

Methods and procedures for the authorization of transactions, the safeguarding of assets, and the accuracy of accounting records.

Accounting cycle

The accounting cycle is made up of the steps repeated each reporting period for the purpose of preparing financial statements for users. The net results of these steps is that the organization then has a set of procedures for analyzing, recording, classifying, summarizing, and reporting its financial transactions.

Accounting standards

Authoritative standards for financial accounting and reporting developed through an organized standard-setting process and issued by a recognized standard setting body that is independent of the organization to which the standards apply. Accounting standards specify how transactions and other events are to be recognized, measured, presented, and disclosed in government financial statements. The objective of such standards is to meet the needs of users of financial statements by providing the information needed for accountability and decision making.

Accounts payable

Amounts owed to suppliers.

Accounts receivable

Money owed to the organization or individual in exchange for goods and services it has provided, or for obligations such as taxes, fines, and duties.

Accrual basis of accounting

An accounting system that records revenues in the period in which they become earned (whether received or not) and the expenses in the period that resources are used. Therefore, the transactions and events are recorded in the accounting records and recognized in the financial statements of the periods to which they relate.

Accrual output budgeting

Form of budget system currently in use in the United Kingdom, New Zealand and Australia, based on performance budgeting, that places the entire budget for each department on an internal market or purchaser/provider basis. Governments purchase services and products from department in market-type transactions. Departments treat government funding as revenue, and have their own profit and loss statements. This is intended to encourage competition and maximize the use of internal resources.

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Activity statement

Financial statement that reports the results of operations over a period of time (revenues and expenses), as well as other changes in the net assets of the organization.

Activity-based costing

Cost measurement system that focuses on activities of the organization so that an understanding is developed of the costs of each type or service offered.

Agency review

A review which covers a whole government organization (ministry or other agency), and which may cover all of the agency's programs and processes in order to find savings for budget reduction or reallocation.

Aging schedule

Management report that shows how long receivables have been outstanding since an invoice was issued.

Allocations

Subdivisions of an **appropriation** into more detailed categories, such as business lines or responsibility centres, programs, or **objects of expenditure**. Sometimes, spending is further broken down into **allotments.**

Allotments

A system that allocates budget resources to specific time periods or for use only after a certain event occurs.

Amortization

The writing off, in a systematic manner over a pre-determined number of accounting periods, of a balance in an account. Depreciation accounting is a form of amortization applied to tangible fixed assets.

Annuity

Series of payments or receipts each in the same amount and spaced at even time periods.

Appropriation

Approval by a legislative body of an organization's budget. Appropriations create the authorization for spending the amount in the budget.

Assets

Possessions which have value. In accounting, assets are resources owned, or in some cases, controlled, by an individual or organization as a result of transactions or events from which future economic benefits are expected to flow to that individual or organization.

Assurance

The conclusion provided by an auditor concerning a subject matter of interest to the user. Absolute assurance is not attainable because of factors such as the use of judgement, the use of testing, the inherent limitations of control, and the fact that much of the evidence available to an auditor is persuasive rather than conclusive in nature.

Attestation

A statement by an auditor undertaking to express an opinion on the reliability of assertions made by management in their financial statement, and that the statement conforms with the stated accounting practices of the organization.

Audit

Examination of the financial records of the organization to verify their accuracy, discover material errors, evaluate the internal control system or determine if financial statements have been prepared in accordance with **generally accepted accounting principles.**

Audit criteria

Reasonable and attainable attributes of adequate systems against which the systems being audited can be assessed.

Audit trail

A set of references that allows a person to trace back through accounting documents to the source of any financial transaction. It usually entails a formalized record keeping system.

Audited financial statements

Financial statements that have been examined by a certified accounting professional, who issues an opinion letter, called an auditor's report.

Average cost

Full cost divided by the volume of service units.

Bad debts

Amounts that are owed to the organization that are never collected, or that the organization recognizes it will either never collect, so that it will "write them off" the financial records.

Balance sheet

Financial report that indicates the financial position of the organization at a specific point in time. Often referred to as the **Statement of Financial Position.**

Basic financial statements

Financial statements that must be included in an organization's annual report to comply with GAAP. The required statements are

1. Management discussion and analysis (MDA), which outlines managerial responsibilities for the preparation of the report as well as the signatures of those designated responsible for them.
2. Independent auditor's report, which provides an attestation that the information conforms with established accounting practices.
3. Consolidated statement of financial position
4. Consolidated statement of operations
5. Consolidated statement of changes in net assets/ debt
6. Consolidated statement of cash flow
7. Notes to the statements.

Betterment

Betterments are enhancements to the service potential of a capital asset such as:

1. An increase in the previously assessed physical output or service capacity
2. A reduction in associated operating costs
3. An extension of the estimated useful life, or
4. An improvement in the quality of output.

Bottom-up budget

Budget prepared by **responsibility centre** managers, who inform the top management of their spending plans and needs.

Break-even analysis

Technique for determining the minimum volume of services or goods that a program or service must provide to be financially self-sufficient.

Budget

A plan that provides a formal, quantitative expression of management's or government's plans and intentions or expectations. It generally expresses the amounts that programs have to spend over a fixed period, normally a fiscal year. The legal authority to spend such funds and legal force that limits expenditures to those limits is the **appropriations** voted by the legislature.

Budget reserves

Amounts in the budget that are to be used for unanticipated expenses. These can be identified as contingency funds, reserves for prudence purposes, etc.

Budgetary Transaction

Transaction that affects the net worth of the government.

Business plan

Detailed plan for a proposed program, project, or service, including information to be used to assess the proposal's financial feasibility.

Capital assets

Tangible properties, such as land, building and equipment, and intangible properties such as copyrights with value. Buildings or equipment with useful lives extending beyond the year in which they are purchased or put into service; also referred to as long-term investments, capital items, capital investments or capital acquisitions.

Capital budget

Plan for the acquisition of buildings and equipment that will be used by the organization in one or more years beyond the year of acquisition. This is actually both a budget and a plan: often future year expenditures are not listed for approval, but for information, while the current or upcoming year is often more concrete and detailed, intended to be the actual expenditures for the period.

Capital equipment

Equipment that is expected to last more than one year, and is of significant replacement value, often with a depreciation schedule to assign value over its useful life. Equipment items of lesser value are often not treated as capital, but as supplies, e.g., computer printers.

Capital projects fund

Fund used to account for major acquisitions of plant or equipment.

Carrying costs of inventory

Capital costs and out-of-pocket costs related to holding inventory. Capital costs represent the lost interest because money is tied up in inventory. Out-of-pocket costs include such expenses as insurance on the value of inventory, annual inspections, and obsolescence of inventory.

Cash basis of accounting

Accounting system under which revenues are recorded when cash is received, and expenses are recorded when cash is paid.

Cash budget

Plan for the cash receipts and cash disbursements of the organization. This may be an important document for organizations with cash requirements above their on-hand resources or with organizations that may have to develop a borrowing strategy for the fiscal period.

Cash equivalents

Funds held in bank accounts, short-term certificates – any item that can be readily converted to cash.

Cash flow

Measure of the amount of cash received or disbursed over a given time period, as opposed to revenues or expenses, which frequently are recognized at a time other than when the actual cash receipt or payment occurs.

Cash flow statement

Statement of changes in financial position: statement that summarizes where cash came from and what cash was used for throughout the reporting period.

Cash held in escrow

A term likely to appear on a balance sheet statement when the organization has cash, usually held by a third party, that is reserved for a completed transaction which still requires further conditions to be met before it can be paid, e.g., clearing a regulatory review.

Cash management

This text's definition: Active process of monitoring financial and program activity within the budget of the organization to determine if budgetary requirements will be met, whether they might be deficits or surpluses, within the current year and determining what appropriate action to take in either case.

Alternative definition: process of planning for borrowing and repayment of cash or investing excess cash on hand: this is a more technical exercise of managing available funds to the best advantage of the organization. It is also the more common use of the term.

Chart of Accounts

Accounting document that defines the structure of the financial recording and reporting system of the organization. It would define the elements into which the budget is divided for the organization; it would further assign an identifying number for each possible element of a financial transaction. Transactions are coded and reports generated in a manner consistent with this chart.

Chief Financial Officer

Manager who is ultimately responsible for all the financial functions in the organization.

Collateral

Specific asset pledged to a lender as security for a loan.

Collections

A capital asset, generally held by a not-for-profit organization or public gallery, consisting of works of art, historical treasures, or similar assets that are:

1. Held for public exhibition, education or research
2. Protected, cared for and preserved
3. Subject to an organizational policy that requires any proceeds from their sale to be used to acquire other items to be added to the collection.

Combined balance sheet

Financial statement that presents the **balance sheet** information for all **funds** and account groups. Totals for each **asset, liability** and **fund balance account** across funds may be provided, but are not required.

Commercial assets

An asset, the costs of which are entirely met through the imposition of user charges (i.e., through payments by consumers), and which does not therefore require tax finance.

Commitments

Future obligations or intentions to spend that the organization has that do not appear on the balance sheet. Depending on their use within an organization, these should be taken together with **encumbrances** which are less formal.

Comparative financial statements

Financial statements that present financial information to permit comparison in a number of ways:

- Comparing financial information for one period against the approved budget for that period.

- Comparing financial information for one period against a pre-determined target for that period.
- Comparing financial information for one period to the same period in past year or years reports.

Compound interest

Method of calculating interest in which interest is earned on not only the amount of the original investment but also the interest earned in prior periods.

Conservatism principle

Financial statement must give adequate consideration to the risks faced by the organization.

Consolidated balance sheet

Balance sheet that combines information from all funds, reporting information on an entity-wide basis.

Consolidated Revenue Fund

Term common to Canadian federal and provincial governments to describe the principal operating fund of the government. In principle, all revenues from all government activities are to be placed in this fund.

Constant dollars

Dollar amounts that have been adjusted for the impact of inflation.

Contingent liabilities

Obligations that will exist in the future if certain events occur, such as if the organization loses a lawsuit.

Continuous budgeting

System in which a budget is prepared on a month-to-month basis based on fluctuations in revenue and demand for services.

Contributions

Non-reciprocal transfers to organizations, generally not-for-profit, of cash or their assets or non-reciprocal settlements or cancellations of its liabilities. Government funding provided to a not-for-profit is considered to be a contribution. In the context of some governments, contributions entail some element of reporting accountability back to the government giving the money.

Control

Systems put in place in an organization to ensure that the actual results come as close as possible to planned results. Control can also be systems for monitoring and reporting.

Control framework

The purpose of the control framework is to provide a clear definition of the roles and responsibilities of each party involved in making financial decisions in an organization with the overall goal of providing accurate, complete, useful and timely accounting information which is used in the day-to-day decision-making process by all management levels of the organization. Such a document is part of the overall management control system of an organization. It lays out delegations, authorities, decision routes, and legal requirements as well as reporting requirements for the organization.

Cost

Amount spent on something. Costs have two stages: acquisition or, **unexpired cost** and **expired costs**. When some asset or service is purchased the price is considered to be the acquisition cost. If the item is an asset, the portion that has not been consumed will appear on the balance sheet at its unexpired cost. As the asset is used up, it becomes an expired cost, or an **expense**.

Cost accounting

A subset of accounting related to measuring costs to generate cost information for reporting and making management decisions.

Cost accounting system

Any coherent system designed to gather and report cost information.

Cost allocation

The process of taking costs from areas or cost objective and allocating them to others in order to determine the overall cost of a service, product or unit. This will entail assigning indirect costs, such as information technology or administrative support, to line activities within an organization.

Cost centre

Unit or department in an organization for which a manager is assigned responsibility for costs.

Cost convention principle

GAAP principle that requires assets to be valued at their cost at the time of acquisition.

Cost object

Unit of service, program, organization, or good for which the cost is desired.

Cost-plus or cost-based contract

A construction contract in which the contractor is reimbursed for allowable or otherwise defined costs and, in the case of a commercially-based contract, an additional percentage of the variable costs or a fixed fee.

Cost-benefit analysis

Measurement of the relative costs and benefits associated with a particular project or course of action.

Current assets

Resources the organization has that either are cash or can be converted to cash within one year or that will be used up within one year. Current assets are often referred to as short-term or near-term assets**.**

Current liabilities

Those obligations that are expected to be paid within one fiscal year.

Current ratio

Current assets divided by current liabilities; this liquidity ratio assesses the ability of the organization to meet its current obligations as they come due for payment.

Debt

Liability – an amount owed by one individual or organization to another.

Debt to equity

Debt divided by net assets or fund balance; this leverage ratio considers the relative magnitudes of debt to equity of the organization to assess the risk created by the use of leverage. This ratio is very important in the private sector in terms of the risk of seeking more debt, or the potential for lenders to provide it. However, it sometimes applies to the not-for-profit sector as well.

Decentralization

Delegation of decision-making autonomy downward within the organization, or to centres of service not in headquarters. Delegation should be accompanied by appropriate delegation matrices and accountability frameworks.

Deferral method

Under the deferral method of accounting, expenses of future periods are deferred and recognized as revenue in the period in which the related expenses are incurred. Endowment contributions are reported as direct increases in net assets. All other contributions are reported as revenue of the current period. Organizations that use fund accounting in their financial statements without following the restricted fund method would account for contributions under the deferral method.

Deferred charges

Assets that have been paid for, and have not yet been used, but that will not be consumed in this **fiscal year**.

Deferred contribution

A restricted contribution received or recorded as receivable but carried forward to be taken into income in future periods.

Deferred maintenance

Any maintenance work not performed when it should have been. Maintenance work should be performed when necessary to ensure capital assets provide acceptable service over their expected lives.

Deferred inflow

A deferred inflow is to be used by the entity in one or more specified future reporting periods. An example of a deferred inflow is a multi-year grant transferred to the entity that does not meet the definition of a liability, but includes a stipulation by the transferor that it is to be used to finance the general activities of the entity over one or more specified future reporting periods. A decrease in a deferred inflow would be recognized as revenue.

Deferred outflow

A deferred outflow is to be used by the transferee in one or more future reporting periods. An example of a deferred outflow is a multi-year grant transferred by the entity that contains no conditions, but a stipulation by the transferor that it is to be used for the general activities of the recipient entity or party over one or more specified future reporting periods. A decrease in a deferred outflow would be recognized as an expense.

Deficit

The excess of spending over receipts or budget; excess of expenses over revenues.

Defined benefit pension plan

A plan that specifies either the benefits to be received by employees after retirement, or the method for determining those benefits.

Delegation matrix

A formal document assigning financial and other authorities to specific categories of managers. For example, the authority to approve expenditures up to a certain level would be defined in such a matrix.

Depreciate

Decline in value or productive capability through the allocation of the asset (usually a fixed or long term asset) over the periods it is used or consumed.

Depreciation expense

Amount of the original cost of a fixed asset allocated as an expense each year.

Direct costs

1. Costs incurred within the organizational unit for which the manager has responsibility are referred to as direct costs of the unit.
2. Costs of resources used for direct provision of goods or services or activities that relate to the core mission of the organization are also referred as direct costs.

Disbursement

Cash payment or transfer.

Discount rate

Interest rate used in time value of money analysis.

Discounted cash flow

Method that allows comparisons of amounts of money paid at different points of time by discounting all amounts to the present.

Donor-restricted funds

General class of funds that must comply with various requirements, that donors have placed at the time of the donation, which stipulate how the donations can be used.

Double-entry accounting

Refers to the fact that whenever a change is made to the fundamental accounting equation, at least one other change must be made as well to keep the equation in balance.

Efficiency savings

Savings which are achieved by changing the way in which services are delivered so as to deliver the same quantity and quality of service at lower cost.

Encumbrance

An indication that a certain amount of money has been earmarked for a particular purpose, and is no longer available for other uses.

Endowment

Restricted fund that contains permanent assets that belong to the organization and that may not be spent; only earnings may be removed from this fund under normal conditions.

Endowment contribution

A type of restricted contribution subject to a donor-imposed stipulation specifying that the principal contributed must be held permanently, but may earn income through investment. This income would then be available for a restricted use.

Endowment fund

A self-balancing set of accounts which reports the accumulation of endowment contributions. Under the restricted fund method of accounting for contributions, only endowment contributions, and investment income subject to restrictions stipulating that it be added to the principal amount of the endowment fund, would be reported as revenue of the endowment fund. Allocations of resources to the endowment fund that result from the imposition of internal restrictions are recorded as inter-fund transfers.

Enterprise fund

Term seen in reference to a fund used to account for government services provided on a business basis. The operation of a municipal golf course may use such a fund for its accounting purposes.

Entitlements

Benefits that must be given to any individual who meets eligibility criteria specified in the law which created the entitlement.

Entity

Specific individual, organization, or part of an organization that is the focus of attention; accounting must be done from the perspective of the relevant entity and the definition of that entity must be applied consistently.

Enterprise Crown corporation

A corporation, which is not dependent on legislated appropriations, and whose principal activity and source of revenues are the sale of goods and/or services to outside parties. An enterprise Crown corporation is ultimately accountable to the legislature, through a minister of the Crown, for the conduct of its affairs.

Equities

The right-hand side of the balance sheet, i.e., the liabilities and net assets combined.

Equity

Ownership, e.g., the share of the house that is owned by the homeowner free and clear of any mortgage obligations, is the homeowner's equity in the house.

Estimates

The main estimates are government documents providing a detailed breakdown of government spending for the upcoming fiscal year. The main estimates for the Canadian federal government are issued with a blue cover and are often called the blue book.

Exception report

A report of individual items, such as cash forecast variances, that exceed a specified limit or planned expectation. Often such reports are "rolled up" into a summary report for senior management review.

Expenditure

Term used instead of expense in modified accrual systems to contrast timing of recognition from when the item is used (expense under accrual) to when an obligation is incurred to pay for the item using current financial resources (expenditure under modified accrual or cash).

Expense accrual

Term used to distinguish the accrual basis of accounting from the governmental modified accrual basis of accounting.

Expense or expensed

Decreases in economic resources, either by way of outflows, reductions of assets, or incurrence of liabilities, resulting from an entity's ordinary activities. Also, a cost that is properly identifiable with the operations of a period, or with revenues earned during that period, or that is not identifiable with the operations or revenues of a future period or periods.

External accountant

Accountant who is not an employee of the organization; often hired to perform an audit of the organization's financial records. In the public sector, this could be the legislative auditor, e.g., the auditor of the province.

Factoring

Selling or disposing of the organization's accounts receivable, usually for less than their face value. This will occur when it is easier to do this than collect the receivables in the usual way.

Fair market value

Amount of the financial consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Favourable variance

Variance in which less was spent than what was budgeted. Such a variance may not been seen as favourable from the perspective of the program's objectives or the clients of the program.

Fee-for-service

System in which there is an additional charge for each additional service provided.

Fiduciary

Relating to holding something in trust; a trustee maintaining assets in trust on behalf of a person who is not yet old enough to determine how to spend them.

Fiduciary funds

Trust or agency funds used to account for resources held by a trustee or agent.

FIFO

See first-in, first-out.

Financial accounting

Financial accounting is concerned with providing information to stakeholders outside the organization in prescribed ways that establish credibility for the organization and determine compliance with applicable legal requirements. Often this is in the form of structured reports such as the Balance Sheet or Cash Flow Statement.

Financial assets

Assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of government operations, e.g., cash, a realizable asset that is convertible to cash, a temporary investment.

Financial budget

The operating budget and the capital budget combined.

Financial condition analysis

An analysis of the financial status of a government organization based on a financial statement analysis as well as an evaluation of external factors that affect the financial condition of the government, or part thereof, such as the wealth of the population, employment rates, interests rates, service demand, or the general economy.

Financial management

The part of management that focuses on the use, management, and effectiveness of financial resources to achieve objectives as well as the use of financial techniques and expertise to provide information for decision making, assuring optimal use of the resources and providing assurances of probity and propriety in their use.

Financial statement analysis

Analysis of the viability and effectiveness of an organization done by reviewing financial statements, including the accompanying management analysis and explanations, auditor's (both internal and external) reports, the use of comparative data, and taking environmental factors into account.

Financial ratios

The use of ratios to compare various elements of financial statements that enable analysis of the performance and relative position of the agency. Used consistently they provide temporal and organizational performance comparisons and show a quick point of departure for first evidence on the overall financial position of the entity. Example: current ratio as defined as current assets divided by current liability, which measures the entity's capacity to meet current obligations.

Financial statements

Reports that convey information about the organization's financial position relative to its plans, objectives, obligations, and the results it is achieving.

First in, first out (FIFO)

Inventory costing method that assumes the oldest inventory is used first.

Fiscal capacity

The extent to which a government can raise money to provide goods and services to its citizens within its economic, legal, and political constraints.

Fiscal year

One-year period defined for financial and planning purposes. It may start at any point in the calendar year.

Fixed assets

Those assets that will not be used up or converted to cash within a fiscal year; referred to as long-term assets.

Fixed costs

Costs that do not change in total as volume changes within the **relevant range.** These costs do not normally increase or decrease as volume rises or falls with normal operating levels.

Flexible budget

Budget that is adjusted for volume of output.

Flexible budget variance

Difference between actual results and the flexible budget.

Flexible budgeting

Process of developing a budget based on different workload levels. Often used after the fact to calculate the amount that would have been budgeted for with actual workload levels that were attained.

Float

The interim period from when a cheque is written until it is cashed and clears the bank.

FTE

Full-time equivalent of one, full-time staff position. Often expressed as a dollar figure equivalent to either a specific staff position or an average number. Used to allocate funds to part-time or temporary forms of employment.

Full accrual

Accrual basis of accounting; term used to distinguish accrual accounting from government modified accrual basis of accounting.

Full cost

Total of all costs associated with an organizational unit or activity, including both direct and indirect costs.

Full disclosure

GAAP principle that requires that information conveys material financial information that the financial statements do not adequately disclose.

Fund

An accounting entity with its own separate set of financial records for recording and reporting assets, liabilities, fund balance and changes in fund balance.

Fund accounting

Comprises the collective accounting procedures resulting in a self-balancing set of accounts for each fund established by the legal, contractual, or voluntary actions of an organization. Fund accounting involves an accounting segregation, although not necessarily a physical segregation, of resources. Movement of resources between funds is often restricted by specific rules, or requiring specific authority, perhaps even legislation or changes to budget provisions.

Fund balance

The equivalent of owner's equity or net assets in a fund accounting system; equal to assets, less liabilities.

Fungible

Interchangeable – subject to interpretation.

Future value

The amount a present amount of money will grow to be worth at some point in the future.

GAAP

Generally accepted accounting principles: set of rules that must be followed for the organization's financial statements to be deemed a fair representation of the organization's financial position.

General fund

A self-balancing set of accounts which, under the restricted fund method of accounting for contribution, reports all unrestricted revenue and restricted contributions for which no corresponding restricted fund is presented. The fund balance represents net assets that are not subject to externally imposed restrictions.

General journal

First place that financial transactions are entered into the accounting records; chronological listing of all financial events, e.g., sales, payments, receipt of transfers.

General ledger

Book of accounts; listing of the balances and all changes in each of the organization's accounts. This is more often a computer system than a physical book or file.

General operating fund

Unrestricted fund used for the routine and operational activities of the organization.

Going-concern principle

GAAP principle that involves assuming that the numbers reported on an audited financial statement are those of an organization that will continue in business for the foreseeable future.

Goodwill

Intangible asset that represents a measure of the value of the organization that goes beyond its specific physical assets. Not normally applied to government operations.

Governance

Governance is a process and structure that brings together capable people and information to achieve goals. It guides an organization to achieve its goals and ensures the effective use of resources. The process and structure clearly define the organization's accountability systems.

Government business enterprise (GBE)

An entity that has all the following characteristics:

1. It has the power to contract in its own name.
2. Financial and operational authority has been assigned to carry on a business.
3. In the normal course of its business, it sells goods and services to other entities at a profit or full cost recovery.
4. It is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length.
5. It is controlled by a public-sector entity.

There are many forms of GBEs in Canada. One good example is any Crown corporation.

Income statement (or earnings statement)

A financial statement that reports revenues and expenses for a given period of time. It is intended to portray cumulative operational results for a given period of time.

Incremental budgeting

An approach to resource allocation that simply adds a set percentage or amount onto the prior year's budget allocation.

Incremental costs

Additional costs that will be incurred if a decision is made to increase production, levels of service, or volume within an existing program.

Indirect costs

1. Costs that are assigned to an organizational unit from elsewhere in the organization are indirect costs for the unit, e.g., IT support.
2. Costs within a unit that are not incurred for direct provision of goods or services, i.e., core business or mission central, but are nonetheless needed to provide those services, e.g., logistical support, physical plant, or financial services.

Infrastructure

Stationary assets with extremely long life-cycles, e.g., bridges, tunnels, dams, roads, and similar assets.

Inputs

Resources used for producing the organization's output. Examples are labour and supplies.

Intangible assets

Assets without physical substance or form. This can include goodwill.

Intergovernmental fiscal transfers

Any resource flow from one level of government to another, including taxes shared by law.

Interim statements

Financial statements covering a period less than the fiscal year. Quarterly cash forecasts of budget performance, with both historical data for the period of the year that is already over, and projections to the end of the year with a comparison of performance against budget, are interim statements.

Internal accountant

Accountant who works as an employee of the organization, and performs accounting operations on its behalf.

Internal audit

An audit function within an organization that meets its internal auditing requirements, e.g., verifying transactions with pre- or post-expenditure attributes; conducts regular audits of functions on behalf of senior management.

Internal balances

Amounts that one part of the government owes to another part, e.g., central processing operations that charge back to departments their share of the cost for processing cheques on their behalf.

Internal control

1. A system of accounting and performance measurement checks and balances designed to minimize both error and the possibility of fraud or embezzlement.
2. A system of measures, both financial and non-financial, to ensure that the organization is achieving its objectives and targets.
3. The process and systems that ensure that decisions made in the organization are appropriate and have the appropriate authorization.

Internal rate of return

Discounted cash-flow technique that calculates the rate of return earned on a specific project or program.

Internal service funds

Funds established for elements of government that provide specific services to other government units, e.g., information technology.

Inter-period equity

Refers to the extent to which the government uses only revenues from the current period to pay for only services provided in the current period. A surplus for a given year implies that a government is taking resources from the current taxpayers to provide benefits for future taxpayers. A deficit implies that current taxpayers are consuming resources that will have to be paid for by future taxpayers. Thus, a surplus or deficit might be considered to create inter-period inequity.

Inventory

Materials and supplies held for use in providing services or making a product.

Journal entry

An entry into the general journal or a subsidiary journal.

Journal ledger or general ledger

A journal ledger, or journal, is the central recording device to record financial information for accounting purposes. It is a chronological listing of every financial event that affects the organization. It is considered the database, record, file, or book of original entry of information into the accounting system.

Justification

Explanation used in defending a proposed budget or in explaining variances that have occurred.

Just-in-time inventory

An approach to inventory management that calls for the arrival of inventory just as it is needed, resulting in zero inventory levels.

Last in, first out (LIFO)

Inventory costing method that assumes the most recent acquisitions are always used prior to inventory acquired at an earlier date.

Ledger

Accounting book or system that keeps track of increases, decreases, and the balance in each asset, liability, revenue, expense and fund balance or net asset account.

Legislative auditor

An external auditor created by law and generally reporting to the legislative body and not to bureaucracy with the purpose of overseeing government accounts and providing opinions on them, both in terms of compliance with law, policy, and their value for money.

Leverage

The use of debt as a source of financing. Debt increases the risk of the organization because of the requirement to make interest payments.

Leverage ratios

Ratios that examine the relative amount of debt the organization has; sometimes referred to as solvency ratios.

Liabilities

Legal financial obligations the organization has to outsiders. Essentially, this is money that an organization owes to someone.

Line function

Elements of the operation of an organization involved in direct delivery or service or the main reason for that organization's existence.

Line of credit

Prearranged loan to be given when, and if, needed by the organization in an amount up to an agreed-upon limit.

Line-item

Any cost or expense that is listed separately on a budget, e.g., salaries, cost of rentals, etc.

Liquid

Refers to how quickly an asset can be converted to cash. The more quickly an asset can become cash, the more liquid it is.

Liquid assets

Cash or other assets that can quickly be converted to cash to meet the short-term liabilities of the organization.

Liquidity ratios

Class of ratio that examines the ability of the organization to meet its obligations in the coming year.

Long-range plan (or budget)

Plan that covers a number of budget years, generally outlining longer-term plans and budget projections.

Long-term liabilities

Liabilities that are not expected or required to be repaid within the fiscal year.

Long-term restricted funds

Funds that contain restrictions, which prevent them from being used for current operations, e.g., contingency funds, long-term capital investment funds.

Management control system

Complete set of policies and procedures designed to keep operations going according to plan.

Management letter

Letter from an internal or external auditor to the management of the organization outlining audit findings that are not reported in the formal audit reports; often these are minor items, or comments on matters of significance but outside the scope of the audit. Generally, these are not made public with the audit.

Management's discussion and analysis (MDA)

A part of the overall financial reporting that is used by government entities and other organizations to provide the analysis of financial information by line managers or their financial advisors to explain financial events and performance and generally recommend a course of corrective action where needed. This section of the financial report will also list general accounting policies of the organizations and explain any changes that have taken place from the previous reporting period.

Managerial accounting

The generation of financial information that is needed to assist managers in their responsibilities. This is not a special form of accounting, but rather the use of accounting techniques to accomplish the broader control goals of the organization.

Margin

At the edge; usually refers to the impact of adding one more unit of service.

Marginal cost analysis

The process of making decisions based on the marginal costs of the change, rather than on the full or average costs.

Marginal costs

The change in cost related to a change in activity. Includes variable costs and any additional fixed costs incurred because the volume change exceeds the relevant range for existing fixed costs.

Marketable securities

Marketable securities are any form of short-term investment, e.g., stocks, bonds, readily convertible mutual funds, investments or treasury certificates that can be converted to cash.

Master budget

Set of all the major budgets in the organization; generally includes the operating budget, long-range budget, program budgets, capital budget and cash budget.

Matching principle

For a given unit of service provided, the revenues arising from providing that service, and the expenses incurred in proving it, are recorded in the same fiscal period.

Material

1. Amount substantial enough that an error of that magnitude in the financial statements would cause a user of the statements to make a different decision than would have been made if the user had known the correct information.
2. Amount of sufficient political or program importance that either reporting on it, or keeping track of it, is worthwhile, e.g., small grant programs that attract much publicity.

Materiality

In the context of financial reporting, materiality may be judged in relation to the reasonable prospect of an item or the aggregate of items being significant to financial statement users in making decisions. In broader financial management application, it would be an amount substantial enough that an error of that magnitude in the financial statements would cause a user of the statements to make a different decision than would have been made if the user had known the correct information.

Maturity

Due date or end date of a loan arrangement.

Maturity value

The principal amount of a loan to be repaid at the ending date or maturity date of the loan.

Mixed costs

Costs that contain elements of both fixed and variable costs.

Modified accrual accounting

Accounting basis widely employed by governments for recording purposes for governmental funds. Under this basis of accounting, the primary focus is on financial resources. Typical financial resources are cash, investments and receivables.

Modified cash

Basis for accounting under which routine revenues and expenses are recorded on a cash basis, but capital assets are recorded as expenses gradually over the years they are used rather than all in the year the organization pays for them.

Monetary denominator principle

GAAP principle that requires resources on the financial statement to be stated in terms of monetary value and in a consistent manner, e.g., same currency at all times.

Net assets/equity

The residual interest in an organization's assets once liabilities have been deducted. "Net assets/equity" is the term used to refer to the residual measure in the statement of financial position (assets less liabilities). Net assets/equity may be positive or negative. Other terms may be used in place of net assets/equity, provided that their meaning is clear.

Net book value

The unexpired, or unamortized, cost of an asset as carried in the accounting records of an organization. This is the original cost of the asset less the total accumulated depreciation for that asset and any other write-downs, or the original cost of the asset less the total **accumulated depreciation** for that asset.

Net cash flow

Net difference between cash receipts and cash payments.

Net income

Revenue less expense; also called profit in the private sector; could be considered **retained earnings** for the purposes of some not-for-profit organizations.

Net financial position

Net financial position is the aggregate of an entity's assets and deferred outflows less an entity's liabilities and deferred inflows at the reporting date and can be represented by: assets + deferred outflows – (liabilities + deferred inflows) = net financial position.

Net present cost

Aggregate present value of a series of payments to be made in the future.

Net present value

Present value of a series of receipts less the present value of a series of payments.

Net realizable value

Estimated selling price in the ordinary course of business less the estimated costs of completion and sale.

Net working capital

Current assets less current liabilities and encumbrances or commitments.

Net worth

Owner's equity.

Non-budgetary spending

Items excluded from budgetary spending, mainly expenditures under trust accounts managed by the federal government for third parties, such as pension payments from federal government employees' pension plans. Also excluded from budgetary spending in Canada are expenditures under the Canada Pension Plan (CPP), which is administered jointly by the federal and provincial governments.

Non-budgetary transaction

Transaction involving offsetting financial assets and liabilities thus leaving net debt unchanged.

Non-capital asset

A non-capital asset is a physical asset that is below the accounting limit for recognition as a capital asset in the accounts. It is not controlled in the central capital asset register since it costs less than the approved limit. This does not mean that the asset does not have value, but only that it is not cost effective to account for its consumption over more than one financial year. Non-capital assets are often characterized by the fact that they are easily transportable and have general purpose use.

Noncontrollable

Those items over which a manager does not have the authority or ability to control, e.g., the cost of fuel, intake for entitlement programs, emergency room volumes.

Non-exchange transaction

Under a non-exchange transaction, an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving equal value in exchange. In public sector finance, this means that a taxpayer will be taxed at a rate consistent with earnings, not the value of goods and services received from government.

Non-expendable funds

Funds where only a portion of the money within it can be spent.

Non-financial assets

Assets acquired, constructed or developed that do not normally provide resources to discharge existing liabilities, but instead are normally employed to deliver government services, may be consumed in the normal course of operation and are not for sale in the normal course of operations.

Notes payable

Written documents representing a loan that is reported on the balance sheet.

Not-for-profit organizations

Entities, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purposes. A not-for-profit organization's members, contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization.

Object code

A numeric code that is part of the overall budget code structure of the statement of accounts used to identify the nature, purpose or object of each financial transaction. Codes are used in all budgeting and accounting systems for consistent reporting purposes.

Objective evidence principle

GAAP that requires assets to be valued based on objective, rather than subjective, information.

Objects of expenditure

Categories of expenditures required to provide goods and services, such as salaries, inventory, rent, equipment, transfers and other resources.

Off-budget

Items that are not included in the normal government budget process, e.g., revenue from the proceeds of the sale of surplus equipment, some self-financial programs.

On-budget

Items that are included in the normal government budget process, i.e., items for which appropriations would be sought.

Operating

Related to the normal routine activities of the organization in carrying out its primary purpose.

Operating budget

Plan for the day-to-day operating revenues and expenses of the organization, for which formal budget approval and appropriations are sought in government and for which fund raising and grant applications are formulated in the not-for-profit sector.

Operating fund

Fund used to account for the day-to-day operations of the organization and all of its resources, and is not subject to restrictions on their use; also called the general fund or current unrestricted fund.

Operating margin

Profitability ratio that compares the operating profit (operating revenue less operating expenses) with operating revenue. It assesses the profitability of each dollar of revenue generated by the routine activities of the organization.

Operating statement

Compares the entity's revenues and other support with its expenses for a period of time, such as a quarter or a year. Often referred to as an income statement, activity statement, statement of revenues and expenses, profit and loss statement.

Opinion letter

Letter or communication from an accountant to users of the organization's audited financial statements providing the accountant's expert opinion as to whether the financial statements are a fair representation of the financial position and the actual results of the operation of the organization.

Opportunity cost

A measure of cost based on the value of the alternatives that are given up in order to use the resource available. In other words, if an organization chooses one course of action, what does it give up, or is not able to do, as a result of that action?

Opportunity costs of inventory

Carrying costs or costs of having money tied up in inventory rather than in a more active program's use, or for revenue generation purposes in the private sector.

Outcomes

Outcomes are the results an organization tries to achieve. They focus on the goals of the organization.

Outputs

Outputs are goods and services actually delivered by an organization to achieve outcomes. They tell you "how much" and "how many."

Overhead

Indirect costs allocated to a unit or department from elsewhere in the organization both for services provided in support of the unit and as a contribution to common central costs such central offices.

Owner's equity

Residual value after the liabilities of an organization are subtracted from the assets. In the public sector, this would translate as net assets.

Performance audits

Review of the organization's operations, consisting of economic and efficiency audits and program audits.

Performance budget

Plan that relates the various objectives of a cost centre with the planned costs of accomplishing those activities.

Performance measures

Method of assessing progress towards achieving a goal.

Period costs

Costs that are treated as an expense in the accounting period for when they are incurred, regardless of when the organization's goods or services are sold.

Periodic inventory

Inventory method under which the organization records only purchases and uses a count of inventory to determine how much has been used (sold) and how much is left on hand.

Permanently restricted net assets

Net assets that must be maintained in perpetuity because of donor-imposed restrictions.

Perpetual inventory

Inventory method under which the organization keeps a record of each inventory acquisition and sale.

Posting

Process of transferring all parts of a journal entry to the specific ledger accounts that are affected by the entry.

Prepaid expenses

Assets that have been paid for and have not yet been used but that will be used within the fiscal year. These include items such as fire insurance premiums and rent paid in advance of use.

Present value

Value of future receipts or payments discounted to the present value of the money.

Privatization

The legal transfer of ownership from public to private hands, e.g., the sale of Air Canada.

Pro forma financial statements

Financial statements that present a prediction of what the financial statements for a project, program or organization will look like at some point in the future.

Profit centre

A responsibility unit that is responsible for both revenues and expenses. Often referred to in the public sector as revenue centres.

Profit margin

Excess of revenue over expense divided by total revenue; an indication of the amount of profits generated by each dollar of revenue.

Program audits

Reviews of the organization's operations to check for effectiveness. They determine whether the organization's programs are accomplishing their objectives.

Public Accounts

Financial statements for the government that have been audited by the legislative auditor for that jurisdiction.

Public Accounts Committee

At the federal level, a committee of the House of Commons. Such committees exist in most provincial legislatures as well. In either case, they are responsible for overseeing government expenditures. Individual committees still review departmental estimates and expenditure plans, theoretically in greater detail. In general, as well, the legislative auditor, e.g., the Auditor General, will report to the legislature through this committee.

Qualified auditor's opinion

An opinion that, except for the effect or possible effect of one or more particular aspects, the matters subject to audit are in accordance with the criteria against which they were assessed. It is expected that the auditor will clearly state what the qualifications are.

Quick ratio

Cash plus marketable securities plus accounts receivable, all divided by current liabilities. This liquidity ratio is a more stringent test of the ability to meet current obligations as they come due rather than the widely used current ratios. Sometimes called the acid test.

Rate variance

Price variance that relates to labour resources. In such cases it is typically the hourly rate that has varied from expectations.

Recognition

The point at which a financial event is considered to have occurred and can be recorded in the financial records of the entity. The time of recognition differs under the cash and accrual bases of accounting.

Representational statement

The expression of the opinion, usually by an auditor, that all the financial statements are accurate to the best of his or her knowledge and that they have been prepared in a manner consistent with the policies of the organization and GAAP.

Reservation, reservation of opinion

A generic term for an adverse, or a qualified, auditor's opinion.

Residual value

Estimated net realizable value of a capital asset at the end of its useful life to an organization.

Responsibility

Identifies the field within which a public office holder (whether elected or unelected) can act; it is defined by the specific authority given to an office holder (by law or delegation). – Government of Canada, Guidance for Deputy Ministers, 2003.

Responsibility centre

Part of the organization, such as a department or a unit, for which a manager is assigned responsibility. These are often designed in a hierarchical fashion within an organization, with varying degrees of delegated authority to spend and approve expenditures.

Restricted fund

Funds whose assets are limited in their use. A self-balancing set of accounts, the elements of which are restricted or relate to the use of restricted resources. Under the restricted fund method of accounting for contributions, only restricted contributions, other than endowment contributions, and other externally restricted revenue would be reported as revenue in a restricted fund. Allocations of resources that result from the imposition of internal restrictions are recorded as inter-fund transfers to the restricted fund.

Restricted fund method

Specialized type of fund accounting that involves the reporting of details of financial statement elements by fund in such a way that the organization reports total general funds, one or more restricted funds, and an endowment fund, if applicable.

Retained earnings

The portion of the profits of a for-profit corporation that has been earned over the years, and has not been distributed to the owners in the form of dividends.

Return on investment (ROI)

The ROI is a return ratio that compares the net benefits of a project, verses its total costs. For example, if a project has an ROI of 200 percent, the net benefits derived from the project are double those of the expected total costs to implement the project. As such, the ROI calculation represents the relative value of the project's cumulative net benefits (benefits less costs) over the analysis period, divided by the project's cumulative total costs, expressed as a percentage.

Revenues

Amounts of money that the organization has received or is entitled to receive in exchange for goods or services that it has provided.

Revolving fund

A revolving fund is a statutory parliamentary authority to use the revenues generated from an activity to finance it. This authority generally continues from one year to the next without further authority from Parliament. Although surpluses or deficits may occur from year to year, they are generally expected to balance out over time. A revolving

fund should support increased cost effectiveness, optimal use of resources, responsiveness to clients and good business practices, when used in conjunction with other appropriate arrangements. Such arrangements include the legal and policy framework governing the provision of government services, leadership of the organization and the system of rewards and incentives.

Risk

Anything that affects an organization's ability to achieve its goals.

Risk exposure factor

Investment revenue, intergovernmental revenue, and transfers-in all divided by controllable tax revenue; this ratio assesses the relative share of a government's resources that come from sources it does not control, as compared with the share that comes from a tax base it does control.

Risk management

Systematic steps an organization puts in place to deal with the risks that it faces.

Rolling forecast

Forecasts can be plans for expenditures and revenues or a projection of the cash flow for a given period, normally a fiscal year. With a rolling forecast the number of periods in the forecast remain constant so that if, for example, the periods of the forecast are monthly for 12 months then, as each month is traded, it drops out of the forecast and another month is added to the end of the forecast so there is always forecasting for 12 monthly periods into the future.

Self-financing program

Program in which the costs of delivery are recovered through an autonomous revenue source, such as fees, that are not placed in the **consolidated revenue fund**, but retained in a special fund to pay for the program.

Sensitivity analysis

Process whereby the financial results are recalculated under a series of varying assumptions and predictions. This is often referred to as "what-if" analysis.

Sinking fund

Segregated assets to be used for replacement of plant and equipment, or the repayment of a long-term liability such as a bond.

Solvency

Ability to meet current and future obligations.

Specific authorization

Requirement that a person get written permission to override general authorization policies.

Spending variance

The equivalent of the price or rate variance for fixed and variable overhead costs.

Statement of activities

Statement that provides information about the revenues and expenses of the government as a whole, as well as other changes in net assets.

Statement of cash flows

Provides information about the sources and uses of cash by the organization in carrying out its operating, financing, and investing activities for the period.

Statement of changes in net assets

Provides information about change in the portions of net assets attributable to endowments, capital assets, and other internal and external restrictions.

Statement of financial position

Presents the organization's economic resources, obligations, and net assets at the reporting date. Financial report that indicates the financial position of the organization at a specific point in time. Often referred to as the **balance sheet.**

Statement of net assets

Balance sheet presented in a format of assets less liabilities which equal net assets.

Statement of operations

Presents information about changes in the organization's economic resources and obligations for the period.

State-owned enterprises

See **Government business enterprise.**

Straight-line depreciation

Technique that allocates an equal portion of a long-term asset's cost as an expense each year.

Subsidiary journal

Detailed journal where original entries are first made, with only a summary total entry being made to the general journal.

Subsidiary ledger

Ledger where detailed information is recorded, with only a summary being posted to the general ledger.

Sunk costs

Costs that already have been incurred and will not be affected by future actions.

Systems (accounting)

A set of interrelated accounting control processes relating to revenue, disbursements, the preservation or use of assets, or the determination of liabilities.

Systems (management)

A set of interrelated management control processes that are designed to achieve business goals economically and efficiently.

Tangible capital asset

A non-financial asset having physical substance that:

1. Is held for use in the production or supply of goods and services
2. Has a useful economic life extending beyond an accounting period
3. Has been acquired to be used on a continuing basis.

Tax expenditure

Loosely, a tax exemption or advantage, sometimes called an incentive or loophole; technically, a loss of governmental tax revenue attributable to some provision of federal tax laws that allows a special exclusion, exemption, or deduction from gross income or that provides a special credit, preferential tax rate, or deferral of tax liability. The tax exemption or advantage is usually intended to assist a certain group, or to encourage a certain activity, such as the purchase of homes

Tax transfer

A federal tax transfer involves the federal government ceding some of its "tax room" to provincial governments. Specifically, a tax transfer occurs when the federal government reduces its tax rates to allow provinces to raise their tax rates by an equivalent amount. With a tax transfer, the changes in federal and provincial tax rates offset one another and there is no net financial impact on the taxpayer. Tax transfers represent a growing source of revenue for provinces since they increase in value over time with growth in the economy.

Time value of money

Recognition of the fact that money can earn compound interest and, therefore, a given amount of money paid at different points in time has a different value; the further into the future an amount is paid, the less valuable it is.

Time-series model

Forecasting approach that uses trends and seasonal patterns in the past as a predictor for the future.

Top-down budget

Budget prepared by top management.

Total debt-to-equity ratio

Total liabilities divided by fund balance. The higher this ratio, the less borrowing capacity the organization has available.

Total margin

Profitability ratio that compares the excess of revenues over expenses with total revenues to determine the overall profits earned, including all sources of revenues and expenses, per dollar of revenues.

Transfer Payment

A transfer of money from a government to an individual, an organization or another government for which the government making the transfer does not:

1. Receive any goods or services directly in return as would occur in a purchase/sales transaction
2. Expect to be repaid in the future, as would be expected in a loan, or
3. Expect a financial return, as would be expected in an investment.

Transfer prices

The amounts charged to one responsibly centre for goods or services acquired from another responsibility centre in the same organization.

Unexpired costs

Costs of an asset that have not yet been used up.

Unrestricted funds

Funds whose assets may be used for any normal purpose; usually only the general operating fund is unrestricted.

Use variance

Another name for the quantity variance, so called because the quantity variance focuses on how much of a resource has been used compared to what was predicted or planned.

Useful life

The estimate of the period over which a capital asset is expected to be used by an organization, or the number of production units that can be obtained from the capital asset. The life of a capital asset may extend beyond its useful life to an organization.

Value added

Costs that directly affect the quality of the ultimate produce or service provided.

Value-for-money audit

A comprehensive form of auditing to determine if funds spent achieved the best return on investment, or were spent in the most effective means possible and according to the stated objectives. This form of audit borders on formal evaluation and policy analysis and is well beyond the narrow definition of **audit** per se.

Variable costs

Costs that vary in direct proportion with volume.

Variance

The difference between the budget and the actual results. Also, the difference between projected costs or volumes and actual results.

Variance analysis

Actual results compared with the budget or projections (or previous similar reporting period), followed by investigation and reporting to determine the cause of the variance.

Working capital

The amount of capital, or current assets available, for use in operating the entity. Commonly calculated as the amount by which current assets exceed current liabilities. It does not include fixed assets or such matters and accounts receivable as they are not available to operate the entity.

Write-off

Eliminate an asset from the accounting records and record it as an expense: term often used in its place: taking a charge.

Zero-based budgeting (ZBB)

Budgeting approach that requires an examination and justification of all costs rather than just the incremental costs and that requires examination of alternatives rather than just one approach: each budget year starts at zero and is built up, rather than added to or modified based on previous years' budgets.